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THE IMPROVING BUDGET OUTLOOK

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE, PRODUCTIVITY, AND ECONOMIC GROWTH

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

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THE IMPROVING BUDGET OUTLOOK

TUESDAY, MARCH 18, 1986

Congress of the United States,
Subcommittee on Trade, Productivity,
and Economic Growth of the
Joint Economic Committee,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-342, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the subcommittee) presiding.

Present: Senators Roth and Symms.

Also present: Chris Frenze, professional staff member.

OPENING STATEMENT OF SENATOR ROTH, CHAIRMAN

Senator Roth. The subcommittee will please be in order.

I'd like to welcome our distinguished witnesses who will be testifying this morning, and I'd like to reiterate the objectives of this hearing.

Today, we will examine the financial character of the Federal Government, specifically looking at any hint of future improvement, and we will pay special attention to the role, if any, that tax increases play in that future.

I think it's appropriate to begin by saying we have recently emerged from the dark haze of a nebulous future so far as it relates to the budget; nevertheless, we must still watch our every step. It was then that the growth rate of Federal outlays was burying our economy and it appeared that huge and ever-growing deficits loomed somewhere beyond our vision. Their sheer size made congressional efforts to seriously reduce outlay growth look almost hopeless.

Nervous as this made us, we groped about for anything that would lift the fog and many contended that any politically acceptable effort to reduce the deficit must include significant tax increases.

It was argued that to rely on spending restraint alone was impossible. Even if it were, many persisted, the cuts needed to achieve any good would result in fatal cuts in basic programs and the lowering of the safety net.

But now for the good part. Since the recent release of the Congressional Budget Office baseline and the Office of Management and Budget service estimates, the haze has lifted. Though they differ in a number of respects, both agencies forecast declining budget deficits under current policy.

Instead of the $300 billion deficit range that overshadowed our 1991 projection, we are looking at a new estimate of $104 billion according to the CBO and OMB.

But, as I said, we must walk cautiously. We cannot expect the deficit to melt away of its own volition, but we must see these new OMB and CBO projections as an eye in the storm, and we must act now to prepare for tomorrow.

But, we can now act with greater promise of success from our sacrifice.

Consider, for example, what would happen if Congress reduced baseline outlay growth by the $37 billion needed to meet the Gramm-Rudman target. This would require a reduction in budget authority sufficient to lower both 1991 outlays and the deficit by much more than $37 billion.

Applying this to the CBO baseline would move us toward compliance with Gramm-Rudman over the next 3 fiscal years, even if no further steps were taken.

However, we should—and in my opinion, we must—focus our attention on the spending side of the budget if we are to reduce deficits. Federal spending as a share of national output is currently at very high levels.

But, above all, we must not continue to cloud our Nation's financial future with tax increases that will only prove counterproductive. To do so would stifle economic growth and encourage congressional spending and the deficit would only continue to grow.

Now we have had word that Mr. Miller will be here briefly. I gather there is a massive traffic jam, so we will wait a few minutes and if he doesn't come soon, we will proceed with the other witnesses.

The subcommittee is in recess.

[A short recess was taken at this point.]

Senator Roth. The subcommittee will please be in order. Before proceeding, Senator Mattingly has requested that his written opening statement be placed in the hearing record. He is unable to be present due to other commitments.

[The written opening statement of Senator Mattingly follows:]

OPENING STATEMENT OF SENATOR MATTINGLY

MR. CHAIRMAN, I AM PLEASED THIS HEARING HAS BEEN CALLED CONCERNING THE IMPROVING BUDGET OUTLOOK. I THINK IT IS EXTREMELY IMPORTANT THAT IT BE UNDERSTOOD THE ECONOMY IS IMPROVING AND A TAX INCREASE WOULD CERTAINLY BE COUNTERPRODUCTIVE.

THERE IS QUITE A BATTLE GOING ON HERE IN WASHINGTON. IT IS BETWEEN THOSE WHO SAY WE CANNOT CUT SPENDING ANY MORE AND WE MUST RAISE TAXES ---- AND THOSE WHO SAY WE MUST BRING THE DEFICIT UNDER CONTROL BY CUTTING SPENDING, NOT RAISING TAXES. I AM ON THE SIDE WITH THE MAJORITY OF THE AMERICAN PEOPLE -- THOSE WHO SAY WE DON'T NEED TO RAISE TAXES....THAT WE MUST NOT RAISE TAXES.

I BELIEVE A TAX INCREASE WOULD SERIOUSLY IMPEDE OUR ECONOMIC EXPANSION. IT WOULD SLOW ECONOMIC GROWTH. IT WOULD BE OF NO

BENEFIT AT ALL. THE TRUTH OF THE MATTER IS TAX INCREASES REDUCE THE ECONOMY'S REAL OUTPUT, WHILE SPENDING REDUCTIONS LEAD TO A HIGHER REAL OUTPUT. OUR POLICIES MUST ENCOURAGE CONTINUED ECONOMIC GROWTH.

YET THE STRUGGLE GOES ON. I AM PLEASED THAT THE COMMITTEE WAS ABLE TO ARRANGE TO HAVE SUCH AN OUTSTANDING GROUP OF WITNESSES TO APPEAR BEFORE US TODAY. I AM LOOKING FORWARD TO THEIR VIEWS ON WHY A TAX INCREASE IS THE WRONG ROUTE TO TAKE.

Senator ROTH. Mr. Miller, knowing that you were delayed in a traffic jam, we proceeded with the opening statement, so we are ready for you to begin.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Thank you, Mr. Chairman. I apologize. It seems like construction between here and the White House is on a regular basis now and I wonder whether it's an impediment to our getting together.

Senator ROTH. I hope not.

Mr. MILLER. Mr. Chairman and members of the committee, there is a fiscal struggle going on in our Nation. It's a struggle between those who are telling our elected representatives we can't afford to cut spending any further—we must raise taxes—and those who say we must bring the deficit under control—not by raising taxes, but by cutting spending. The President comes down on the side of the latter, and, if the polls are to be believed, so does a majority of the American people. If we in government will just listen to the people, I'm sure this struggle will end properly and we'll make the right decision.

Today, I'd like to talk about taxes and the damage they can do. I'd also like to talk about the growth of Federal spending, because that's the cause of the deficit.

Now let's get straight to the point: Why is the administration opposed to a tax increase? True, voters don't like to pay higher taxes, but do you really think currying favor with voters is the only reason for opposing a tax increase? Of course not, and it is certainly not to curry favor with the press—on the whole, the media has been pillorying us on this one for 5 years. Well, I'll tell you why: A tax increase under the present circumstances would jeopardize our economic expansion—and I suspect many voters know that, which is one reason for their opposition.

Let me explain. Raising tax rates reduces incentives for Americans to work, to save, and to invest, thereby depressing the prospects for continued economic growth. Since only the foolish would presume that increased tax revenues would be used solely to finance the deficit, raising taxes would transfer resources from the private sector to the Government, which at the margin is less productive. In the process, the economy would lose efficiency and vitality.

Furthermore, the allocative costs of taxes are notorious. According to some studies, for every dollar of tax revenue raised by the personal income tax, we lose as much as 55 cents in economic activity. This is on top of the excessive costs of delivering many Government services. Did you know that for some programs over 50 percent of the money goes for administrative expenses rather than the benefits?

When you add it all up, increasing taxes is a poor way of coping with the deficit.

During the last decade, a combination of increases in some tax rates and inflation-induced bracket creep raised marginal tax rates on real wages and incomes from capital. The result was a slowing in our historic economic expansion.

It wasn't difficult to see what the problem was: Spending was climbing ever upward, while the burden of steadily rising taxes was dragging the economy into a slower growth trajectory. While revenues had tracked economic growth, spending over the decade climbed from 19.8 percent of GNP to 22.2 percent.

Beginning in 1981, we started to change things. An across-the-board reduction in individual tax rates amounting to 23 percent over 3 years was enacted to encourage greater savings and work effort. To prevent bracket creep, tax brackets and exemptions were indexed for inflation beginning in 1985. And a system of accelerating depreciation was allowed to spur capital formation. Even though these and other measures did not get immediate results, their ultimate effects on investment and growth have been quite pronounced.

While the tax cuts of 1981 were a watershed, they were not all many had hoped for. Later, the Tax Equity and Fiscal Responsibility Act of 1982 offset some of the reductions given to business. And, the revenue provisions of the Social Security Amendments of 1983 increased payroll taxes in subsequent years. Furthermore, the Deficit Reduction Act of 1984 and other changes in the Tax Code raised by some $100 billion. In total, nearly 40 percent of the 1981 tax savings have been reversed.

Now, what has happened to spending during all of that time? First of all, promised spending cuts have generally not been forthcoming. In return for the President's accepting a $100 billion tax increase in 1982, Congress promised three times as much in spending reductions. Well, Congress never came up with its share.

Instead, during the last 5 years, spending has grown from 22 percent of GNP to 24 percent. The deficit has widened from 2.8 percent of GNP to 5.4 percent.

Of course, some will blame defense—someone is always blaming defense. Indeed, there have been some necessary increases in defense, but as a share of GNP, defense is taking less today than it did for any peacetime year of the Kennedy-Johnson administration.

As you know, the President agreed to a major reduction in the defense buildup last August in hopes of getting some real cuts in nondefense areas. This agreement amounted to a 5-year reduction in defense budget authority of some $290 billion. But, going one step further, in the fiscal year 1987 budget, defense has been cut an additional $45 billion over 5 years. If the President can live with this lower level of defense, then surely we can cut social programs the 5 cents on the dollar called for in the President's budget.

Sure, we could tax, and tax, and tax some more; but if we do, we could very well end up with the sad experience of the 1970's—slowing economic growth and perhaps accelerating inflation. This would serve no one's interest. Therefore, I earnestly hope the people's representatives will listen to the people on this issue and will save us from the tax, tax, spend, spend evils of the past.

Mr. Chairman, that completes my statement. I shall be happy to address any questions you may have.

Senator ROTH. Thank you very much. It's always a pleasure to have you here.

I guess what concerns me as much as anything is the fact that there has been a dramatic turnaround in budget deficit projections that seems to be neither impacting on those responsible for the budget in the Congress nor getting across to the people at home.

The fact that a proposed deficit of $300 billion has dropped to $100 billion is very, very significant news, but I wonder if you agree with me that this message is not being understood generally by the public at large?

Mr. MILLER. Mr. Chairman, I think you are right. Let me say one major difference between my predecessor's statements that we are looking at $200 billion deficit as far as the eye can see, and this track of decreasing deficits over the next 5 years under current services is due in major part to the President's agreement last August with the Congress to reduce Defense spending by $290 billion over 5 years.

That message I don't think is out there.

The second major source of savings is the interest rate—the interest reduction—and we save there for two reasons:

One, with lower deficits, we have less debt service and, second, we are getting reductions in Treasury rates of interest because of the Gramm-Rudman-Hollings bringing the deficit down, and I think we have seen some response in the real rate of interest falling.

Senator ROTH. Well, now let me ask you this question. In these projections, as I understand it, OMB and CBO come pretty close to the same figure, even though by different routes.

Is that correct?

Mr. MILLER. Yes. The figure for the starting point in 1985 and the ending point 1991, they're within $1 billion of each other in the projections, although the path between them is not necessarily the same.

Senator ROTH. Now, do those projections take into consideration the decline in oil prices as well as the drop in exchange rates or the weakening of the dollar?

Mr. MILLER. I'll let CBO speak for itself. We have not updated our forecast from when the President's budget was submitted on February 5 for the changes in oil prices. As you know, at the time we submitted the budget, there were critics who said that we had overestimated the rate of growth and that we were painting too rosy a scenario.

But since that time, especially with the drop in oil prices, the outside experts have come more around to our way of thinking about the rate of growth. We don't see any reason at this point to revise our estimates. We will be doing that in the summer in our midsession update, but there is no reason to do it right now.

Senator ROTH. I'm not sure I understand why that's the case. There's a significant drop in oil prices. Won't that have a major impact on the economy?

Mr. MILLER. I think everything else being equal it will have a major impact on the economy. It will raise our rate of growth and, in a sense, since we were criticized by some as having too rosy a projection, our feeling is to stick with what we have.

Obviously, our estimate is becoming more the norm now than the exception. But let me just mention the effects of a decrease in oil prices. There are direct effects on the budget and indirect effects.

As for the direct effects on the revenue side, we would lose some taxes and some offshore royalties, et cetera, because of the reduction in the price of oil.

On the other hand, we would save some expenses because, if nothing else, vehicles owned by and operated by the Federal Government would pay lower prices for gasoline.

It's within a fairly narrow range, pretty much a wash on that side. But your point is the more important one, and that is that the fall in oil prices will have a very salutory effect on economic activity overall.

Senator ROTH. Last week, this subcommittee received testimony that indicated that the collapse of oil prices could shave $20 billion off a fiscal 1987 budget deficit. I think that projection was made by Shearson Lehman Bros., which, of course, is a very reputable firm.

Would you consider this forecast fairly reasonable?

If so, wouldn't this drastically improve the budget outlook for fiscal 1987 and the following years?

If not, why not?

Mr. MILLER. Is that their estimate for 1987?

Senator ROTH. Yes; I think it is roughly $20 billion for 1987.

Mr. MILLER. Well, I would presume most of that would be on the revenue side. I think that is an overestimate for 1987, but it would have a salutory effect especially in the outyears, not just for 1987.

Interestingly, I just have to point out that most of the forecasters are indicating that while they think the deficit is falling, they still feel that the long-term deficit is up there; it's not as far downward as OMB and CBO project.

So while they are bringing that line down, they're not necessarily changing the shape of the line or the slope of the line.

Senator ROTH. How do you see the declining value of the dollar impacting on the budget?

Mr. MILLER. Well, it's plus and minus. The decline—we prefer to say, the appreciation of other currencies relative to the dollar—will help our exports. It will curtail some imports. That will be the major effect.

To some extent, it's a wash overall. I think it would be beneficial to us. At the time that we set up and made our assumptions about the economy for 1987 and the outyears, we knew there would be some appreciation. We estimated or assumed there would be some appreciation of foreign currencies relative to the dollar.

Senator ROTH. How about from the standpoint of exports and jobs? Shouldn't it have a beneficial effect?

Mr. MILLER. Yes, it will. But, at the same time, we have a lot of jobs connected to imports and it would reduce them on that side, It would have a number of effects that would ripple through the economy.

It's hard to estimate just offhand what the net effect would be but I think, overall, it would be constant.

Senator ROTH. Let's go back a minute to the oil prices. As you well know, a number of Members of Congress have proposed either an oil import fee or a gasoline tax.

In the latter case, many people have argued that it would not only bring in some revenue and not be inflationary, but it's also proconservation.

Would you favor a gasoline tax?

Mr. **Miller**. I do not. I think it would be a form of taxation that would be particularly restraining on economic activity.

The more you go back to isolating it to say an import fee, the more restraining on the economy the tax would be for the amount of money raised.

A gasoline tax or a broader fuel tax for the same amount of money would have a less depressing effect on the economy than would an import fee raising the same revenue.

But I don't believe either would be particularly appropriate.

Senator **Roth**. As you say, there really has been a lot of criticism that the administration has been overoptimistic in its projections of the economy.

What is the administration's projection for the next 5 years? How does that compare generally with the recent projections in the private sector?

Mr. **Miller**. Well, we're still on the high side of the median projection. As you know, Senator, any time you have 10 economists, you will have 10 different estimates. And there is always a frequency distribution in those estimates.

When we came out with our estimate on most of these, whether it was on unemployment rate or inflation rate or growth rate, we tended to be on the more optimistic side of the average.

But we were still within one standard deviation of the estimate. We're still on the high side in the outyears. We are barely on the high side for 1986 and 1987.

As I was pointing out, the private forecasters are coming more into our way of thinking about the near term, 1986 and 1987. For the outyears, they are more pessimistic than we are.

Senator **Roth**. Let me make sure I understand what you're saying, because even though your projections lean on the more optimistic side, the face is that there are at least two factors which you have not put into your computer that come into play.

A very significant factor is the reduction in the cost of oil. Are there any estimates on what a $10 drop in oil prices means in growth of the economy?

Mr. **Miller**. Yes. I don't have them with me but we are looking at perhaps a percent rate of growth—a percent increase in the rate of growth.

Senator **Roth**. How many billion dollars does that mean? One percent?

Mr. **Miller**. It means a lot of growth. I mean, 1 percent out of a $4 trillion economy, 1 percent is a lot of growth.

Senator **Roth**. I guess that's roughly around $40 billion, so it is significant.

Mr. **Miller**. It sure is.

Senator **Roth**. So you have a very favorable condition with respect to oil. The exchange rate, too, must be considered a favorable factor.

Mr. **Miller**. Yes.

Senator ROTH. So would you say today that even though others may consider your projections fairly optimistic, they lean on the conservative side?

Mr. MILLER. I would not say that an objective appraisal from outside forecasters would be that our assumptions lean to the conservative side. They would probably still say they're a bit optimistic.

But they have come in the last few months very much closer to our own projections. Keep in mind there are people who are saying that we are pessimistic. There are people who believe the rate of growth will be substantially higher than the rate of growth that we project, and if that's true, of course, it means that revenues will be a lot higher and it means that some of our entitlement programs will be less costly than we have estimated here in the budget.

Senator ROTH. Senator Symms.

Senator SYMMS. I just have one general question, Director, that I would like to address to you. You made it pretty clear in your testimony that you think that taxes are not necessary in this budget question. But what will be worse for the economy: a slight revenue number in the budget or a stalemate in the Budget Committee? Won't a deadlock send the signal out to all the markets that Congress can't agree on how to meet the target of Gramm-Rudman?

Is that going to look pretty bad in the financial markets, or do you think they will discount that?

Mr. MILLER. Oh, I hate to answer that, Senator Symms. It's like giving me basket of rotten apples and asking me which ones I want to eat. I don't know.

Senator SYMMS. Well, it's a hard choice, to be very honest. Of course, I voted for the President's budget and I didn't like it either, but there are lots of things that I don't like, but I would say, I think I could write up a budget that woud not have any tax increases. That's the one I would vote for that would, I think, give the signal to the world and the markets that the U.S. Congress is going to meet Gramm-Rudman.

But let's say you can't do that. What happens if we have a deadlock? What does that do to your economic assumptions?

Mr. MILLER. Well, I think a deadlock would be a very bad idea. I think the economy would suffer in two respects: One, because of the perception that Congress can't get together, and maybe the reduction in the deficit is in jeopardy.

Senator SYMMS. Psychologically, that would be bad.

Mr. MILLER. Yes, it would be bad. I think it would lead to some increase in the real rate of interest and that, itself, would have an adverse effect.

Also, I think Gramm-Rudman sequestering itself would have an adverse effect on the economy. That's something to avoid. But, I think for the reasons I have given earlier, I think the tax increase would also be harmful to the economy.

Senator SYMMS. Well, let me put it this way. If, in fact, with the oil prices tumbling and interest rates down, some economists are making estimations now that the budget deficit isn't going to be as bad as it's projected, do you think there would be any merit in having OMB revise their estimates? Maybe all we need to do is cut out some of the spending.

You see, the Domenici package has about $9 billion of additional revenue over and above what the President already has in the $6 billion users fees, which are really another form of taxes but are viewed differently, I guess, inside the beltway.

All I'm, getting at is, considering that we have a $4 trillion economy, surely $9 billion isn't going to make or break it, except maybe phychologically.

Why not revise the estimate if in fact interest rates are going down and oil prices are cheaper than estimated? What is the holdup on revising the estimate? Maybe Senator Domenici's prayers could be answered without the $9 billion in additional revenues and everybody could be happy.

Is that possible?

Mr. MILLER. Oh, it's conceivable, but we just haven't undertaken the exercise. We're not trying to be devious or playing strategy.

Senator SYMMS. Well, maybe it would be less devious not to do anything. Maybe what I'm suggesting is devious.

Mr. MILLER. You know, under the old act, we had a requirement to add an update on April 15. Under Gramm-Rudman, we do that, but we do have an update in the summer. We will make that update.

Senator SYMMS. In the summer?

Mr. MILLER. In the summer. And for all the cynics, it may make some difference.

Senator SYMMS. Well, consider that you are taking off your Budget Director's hat and putting on your economist's hat, is middle summer fast enough?

Mr. MILLER. I think so.

Senator SYMMS. I mean, fast enough to get this whole thing solved?

Mr. MILLER. Well you ladies and gentlemen of the Congress will have to make your judgment about what you think the deficit will be.

We think still probably, all things considered, our estimate of $38 billion is very much in the ballpark. Just weeks before we came out with the budget, I mean, people were saying, well, the budget deficit cuts are going to be $75 billion, or at least $60 billion, over Gramm-Rudman-Hollings and according to the preliminary cut that I had before the budget was released and was relying on, it looked more like $50 billion. But when it came out, it was $38 billion.

Now CBO comes out and says it's practically exactly the same number. Now they used a different methodology; they make different assumptions than we do.

Who knows? It's hard to make those predictions. In a way, I'm resisting the old forecaster's axiom, and that is to forecast often because you're more likely to be right if you update your forecast frequently.

I would guestimate, based on what we know now, that our updated estimate in the summer will cut the deficit projections some. I don't know how much though. Probably not a lot.

To really do a good cut, it requires a lot of work, it really does, and our people right now are very involved in responding to Members of Congress who ask different questions and putting together specific things.

Senator SYMMS. Let me ask one other question.

When do you anticipate the economic recovery that we hear so much about will start having some impact in the resource production sector of the economy—mining, agriculture, timber?

Mr. MILLER. I understand. Well, the figures for the first quarter of 1986 lead me to believe that we are not there yet in terms of the 4-percent rate of growth that we projected for the year, though there is good reason to believe it will rise over the year, fourth quarter over fourth quarter and probably lead to 4 percent.

As to the specific effort upon the mineral industry, the resource industry, that tends to lag in economic activity a bit and so it depends on how quickly the increased rate of growth takes place.

I just don't have a convenient estimate off the top of my head.

Senator SYMMS. Thank you, Senator Roth.

Senator ROTH. Thank you very much, Mr. Miller.

I would like to go back to whether it's better to try to reduce the deficit through spending cuts or by revenue increase. Again, as I understand, what has happened is that it is the spending side that has expanded rapidly in recent years, going up roughly 4 percent to around 24 percent of GNP.

Mr. MILLER. That's correct.

Senator ROTH. And it is not correct to say that the Reagan tax code in 1981 is responsible for the deficit when in fact the revenues we get are roughly the average since World War II.

What is it, 18.5 percent? Something like that?

Mr. MILLER. Well, it's ranged over time, in the recent decade or so, between 18 and 19 percent, or a little higher.

Senator ROTH. So, again, it's the spending side, not the revenue side, that has resulted in this deficit.

Let me ask you one further question before I dig a little more into this aspect of the problem. You said there has been a great change in projections, $104 billion, far better than anybody anticipated a few months ago.

Why can't that reverse itself very quickly? You have, for example, the OPEC countries meeting with other oil producers. How certain can we be that these more favorable projections will continue or can they just disappear rapidly?

Mr. MILLER. They are at risk. OPEC can get together and raise havoc with oil prices. We could have a deterioration in the economy from unexpected quarters and so those estimates that we have out there won't hold up.

I mean, I think, everything else being equal, the further into the future your projections, the less comfort you have in them. So we are a lot more confident about 1986 and 1987 than we are, say, for 1988 and 1989, 1990 and 1991. But it surely could turn around.

And I think the risks are greater, frankly, that there could be a downturn than an asymetric upturn in the economy in terms of its effects on the deficit.

But you just can't put that in quantitative terms, Mr. Chairman. Under current services, I think it's more likely—I hate to say this, but I think it's more likely you'll get a $200 billion deficit in 1991 than a zero deficit in 1991 without any change in policy.

Senator ROTH. Right.

Mr. MILLER. Of course, the budget that the President has proposed deals with that by bringing the deficit down to zero.

Senator ROTH. I'd like to look at the relationship between the budget authority and outlays, which I think is illustrated by CBO on page 65 of their Economic Budget Outlook.

Now, there they describe the effects of the mark sequestering as the following:

> The sequestering of the 1986 spending authority under the provisons of the Balanced Budget Act reduces spending not ony in 1986 but as indicated above in later years as well. The sequestration reduces the 1986 outlays by $11.4 billion because spending authority had to be cut by about twice as much as required outlay reduction and because most of the reduction in spending authority is assumed to continue in later years. The savings from the 1986 sequestration will amount to $16.3 billion in 1987 and to $20.3 billion in 1990.

Mr. MILLER. Well, I haven't inspected that, but the principle is clear. We sequestered about $24 billion in budget authority in 1986 in order to reduce to meet the Gramm-Rudman sequestration for 1986.

We reduce spending by the target of $11.9 billion, so some of that budget authority would play out in subsequent years. And, of course, there would be a lower base from which you began some of those programs.

Senator ROTH. Well, if it's the case that the restraint of certain programs does result in outyear outlay reductions, does this suggest trimming, where appropriate, is a much better route than raising taxes?

Mr. MILLER. Well, I think, as the President's budget has, I think cutting spending is a preferred route. The President's budget cuts $3 billion from Defense for 1987, the way we measure it, and also cuts $22.4 billion from domestic spending, and that's off a base of $418 billion.

That's a 5.3-percent spending reduction, and much of this is tailored in such a way that it tries to hit the overhead and tries to improve efficiency so that we don't cut into the muscle of those programs.

It seems to me that 5 cents on $1 is a small sum to ask for cutting domestic programs.

Senator ROTH. I have no further questions but I appreciate your coming up here today, Mr. Miller, and I'll look forward to working with you the rest of the year in an effort to reduce the deficit through spending reductions and not through a tax increase.

Mr. MILLER. Absolutely. I agree. Thank you, sir.

Senator ROTH. Thank you.

At this time, I'm happy to call forward a panel including Mr. Paul Craig Roberts, who, among other things, is with the Georgetown Center for Strategic and International Studies; Mr. Richard Rahn of the U.S. Chamber of Commerce; Mr. Richard McKenzie of Washington University in St. Louis; and Mr. C. Lowell Harriss of the Academy of Political Science.

Gentlemen, would you like to start in any particular order?

Mr. Roberts, we'll start from the left and go to the right.

STATEMENT OF PAUL CRAIG ROBERTS, WILLIAM E. SIMON CHAIR IN POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, AND CHAIRMAN, THE INSTITUTE FOR POLITICAL ECONOMY

Mr. ROBERTS. It was nice to hear the Budget Director reaffirm the administration's policy against tax increases. Mr. Chairman, I think it's extraordinary just how wrong the deficit doomsayers turned out to be.

First, the inflation rate collapsed in the face of large and rising deficits; next, real interest rates collapsed, and now the $200-$300 billion structural, as they were called, budget deficits "as far as the eye can see" are, according to the latest projections, disappearing from the horizon.

The deficit hysteria turned out to be based on politics and not on analysis. It is fortunate indeed for the economy and for millions of taxpayers that some policymakers resisted the pressure of doom and gloom and the stampede for higher taxes.

Had the "contingency to tax" been passed in 1983 in keeping with the wishes of the then Budget Director and CEA Chairman, the strong recovery of 1983-84, and the continued economic expansion since, would not have occurred.

Without this recovery and unbroken expansion, the deficit outlook today would be dreary indeed.

The most certain way to worsen the deficit outlook is to raise taxes. There are many reasons that this is so. One is that the spectacle of yet another President flip-flopped yet again on his policies has adverse psychological effects on the economy. The impression that on one is really in charge, or, if he is, doesn't know what he is doing, is never good for business confidence.

Another reason is that the increased, revenue projected—on a static basis—from a tax increase always substitutes, at least in part, for spending restraint. And since the actual revenue gains from a tax increase will be lower than the projected gains, the combination of weakened spending restraint with less than expected additional revenue can actually result in a larger deficit. I think we learned that from the 1982 tax increases known as TEFRA.

Yet another reason is that a tax increase itself could do enough damage to the economy to result in a larger deficit.

Mr. Chairman, the Institute of Political Economy, of which I am the chairman, has used a general equilibrium model of the U.S. economy to estimate the effect of a 10-percent tax increase on labor, a 10-percent tax increase on capital, and a 10-percent decrease in Government spending, that is, a decrease in real Government purchases. The results are in terms of the longrun final equilibrium impact of higher taxes and of spending reductions.

In the short run, the impact of higher taxes on the deficit could be worse than in the long run, if the tax increase throws the economy into recession.

We find that a 10-percent increase in the average marginal tax rate on labor income would, in the long run, raise real Government revenues by about 6 percent. That is, you would get about 6 percent of the projected revenues.

But this revenue gain would not be without its cost. Specifically, its price would be a 1-percent smaller real GNP and a 1-percent smaller real capital stock. That is, it would make us poorer.

A 10-percent increase in the average marginal tax rate on capital income makes even less sense. It would gain no revenues, and real GNP would be about 5.4 percent lower. The real capital stock would be about 10-percent smaller, resulting in a smaller capital-labor ratio and lower labor productivity.

In contrast, a 10-percent reduction in real Government purchases would reduce the deficit by 10 percent in the short run and by more in the long run. Real GNP would rise by 0.4 percent, and the real capital stock would be 1.4 percent larger. Consequently, real Government revenues would rise by about 0.3 percent.

So, obviously, a tax increase is not as effective as spending restraint in reducing the deficit. Furthermore, tax increases reduce the economy's real output while spending reductions lead to higher real output.

The two approaches to deficit control are not equally effective alternatives, and it is time for all policymakers to abandon the pretense that they are.

Mr. Chairman, that concludes my statement.

Senator ROTH. Thank you, Mr. Roberts. Rather than ask questions now, we will let the entire panel speak and then propound the questions that we have.

Mr. Harriss, please proceed.

STATEMENT OF C. LOWELL HARRISS, EXECUTIVE DIRECTOR, THE ACADEMY OF POLITICAL SCIENCE

Mr. HARRISS. Mr. Chairman, Senator Symms, it is always attractive to do good things—with the other fellow's money. Good things for others, good things for one's self.

The attractions of getting the benefits of spending without providing your own money are enormous. This observation helps to explain the upward pressure on Federal spending and why that pressure will continue, unless human nature changes.

There are many good things that can be done by spending money, and there are many things that are stupid, foolish, and counterproductive.

When the dollars of the other fellow's—taxes paid by someone else, or perhaps no one's dollars—that is, Federal borrowing, it's easy to see the benefits and overlook the cost of spending.

By no means, of course, is all Government spending bad or unproductive, but a lot of it is not so good, I am convinced, as if the taxpayer or the saver controlled the use of the funds.

The chairman's letter of invitation raises a question of what has been responsible for the growth of the Federal budget and the growth of the deficit?

There are many problems in responding. The letter mentioned the date of 1955, 30 years ago. At that time, the revenues were slightly under 17 percent of gross national product. They have gone up to 18.5 to 19 percent range. Spending was slightly over 17 percent. It has gone up to the 23.5- to 24-percent range. And what has clearly happened has been that revenues have risen at a rate slightly above that of gross national product over this period; spending has risen a great deal faster. The problem of control seems to be clearly a problem of controlling spending.

There is no need for any academician to tell a Member of Congress how difficult it is to control the growth of Federal spending. I used to argue that if spending had to be paid for by taxes there would be more restraint on its rise. I think there is still some truth in that; however, this belief does not lead to the conclusion that taxes should be increased.

As to reduction of the deficit, let me say that, as prior witnesses have already pointed out, a deficit and a large debt do not necessarily mean that the money-creating mechanism will be used to finance the deficit, and thereby generate inflation.

We have seen declining inflation and rapidly declining interest rates in a period of very large borrowing and growing public debt.

I am not sanguine about the growth of a large public debt. I am old enough to be, I suppose, a little bit of a puritan in the sense that I do not like the notion of passing on to the next generation a large public debt that has not been incurred by increasing productive assets for the economy. Nor am I quite as sanguine as might seem appropriate from the testimony of the Budget Director and other figures in the conclusion that we can wisely prepare for the next few years on the assumptions that lie in the new estimates.

I believe that experience indicates that the upward pressure on expenditures is going to be very powerful. In one way or another, human ingenuity will find ways to increase Federal spending.

With so much of the Federal debt being relatively short term, we are vulnerable to a rise in interest rates. Can we count on interest rates as low as are implied in the projections? I do not know.

But with a huge, relatively short-term public debt, there is a vulnerability. Speaking as a responsible economist, I am inclined to say that we should be paying for more of Government spending, that some increase in taxes is desirable. Yet, I am not, by any means, convinced of that position. The overwhelming argument on the other side is one that has already been made—if there is more revenue, there will be an increase in expenditure. The revenue increase will not be used to reduce the deficit so much as to justify increased spending.

You may or may not recall that twice during the 19th century, the U.S. Government debt was essentially repaid. In the 1920's there was a massive reduction, relatively, in the Federal debt. But I do not see anything like that in the situation today.

Therefore, I come out with a general position that a tax increase is an invitation to raise expenditure rather more than to reduce the Government's control of public resources.

However, I do want to insert a good word for the BTT—the business transfer tax. I think it would be a better tax than we have now on business activity. It could represent an improvement in the tax structure. Nevertheless, under present conditions, it is likely to invite more spending. Thank you.

Senator **Roth**. Thank you, Mr. Harriss. Just let me say that, as far as the BTT being used for raising spending is concerned, I realize there is that risk.

[The prepared statement of Mr. Harriss follows:]

PREPARED STATEMENT OF C. LOWELL HARRISS

LOOKING AHEAD ON BUDGET POLICY

Statement at the invitation of the Subcommittee on Trade, Productivity, and Economic Growth of the Joint Economic Committee, U.S. Congress, March 1986, by C. Lowell Harriss, Executive Director; Academy of Political Science; Professor Emeritus of Economics, Columbia University; Associate, Lincoln Institute of Land Policy; formerly Economic Consultant, Tax Foundation, Inc. Views expressed are the author's and not necessarily those of any organization with which he is associated.

It is always attractive to do good things--with the other fellow's money. Good things for others. Good things for oneself. The attraction of getting the benefits of spending without providing the money! This observation helps to explain the upward pressure on Federal spending and why that pressure will continue--unless human nature changes.

New estimates present a Federal budget outlook fundamentally different from that accepted only a few weeks earlier. The deficit, we are informed, will grow smaller. Yet difficult policy issues must still be faced.

Pressures for Spending

There are many good things that can be done by spending money. There are some that are stupid, selfish, and counterproductive. When the dollars are the other person's taxes--taxes paid by others--or, it may seem, no one's--Federal borrowings--it is easy to focus on the benefits and to overlook the costs.

A volume that I recently (1985) edited, Control of Federal Spending (Academy of Political Science), contains information from many sources about aspects of the broad problem. No member of Congress needs words from an academician to emphasize the power of forces to enlarge Federal spending--and the power of forces to prevent the reduction or ending of programs that do not serve the general public well.

Rising Trends

Federal spending has increased relative to the size of the economy.* Outlays including off-budget amounts were well below 20 percent of GNP (except briefly during Korean hostilities) until Vietnam fighting. The 1969 figure of 19.8 was 0.6 above that of 1959.

Then in the 1970s, even though national defense spending declined (relatively), Federal outlays as a percentage of rising GNP fluctuated but ended the decade 2.3 percentage points--more than one tenth--above the level at the start--22.2 in 1980 and 19.9 in 1971. You may remember as I do a recurring refrain during the 1970s under three presidents. We heard repeatedly of the importance of curbing the rise of expenditure and of the resolve to do so. A new budget process (1974) reflected determination to get more effective control. Yet the 1980 amount was $591 billion, compared with the $210 billion of 1971.

* Measuring Federal expenditure presents difficulties, and assessing the significance requires examination beyond money figures. The full influence of commitments will not often appear in this year's outlays. The dollars in Federal grants can have multiplied significance through conditions to which State and local governments respond. Business firms with Federalcontracts may alter practices of the entire company. Insurance and guarantees will accrue liabilities not shown currently in governmental accounts.

New Estimates

The OBM estimates 1986 spending at 23.4 percent of GNP, down from the 1985 figure of 24.0 percent. OBM projects a declining rate so that the 1990 percentage of GNP would be under that of 1971 (19.5 versus 19.9). At $1.1 trillion (eleven hundred times one thousand million dollars), projected spending is almost five times the 1971 amount and 90 percent above 1980. The Congressional Budget Office baseline projections are somewhat higher but also show a dramatic turnaround and significant decline in the deficit.

The five-year increase in Federal debt (OMB) would be more than $700 billion.

Projecting the economy and the Federal sector calls for specialized effort. I have not devoted the time to feel qualified to do more than suggest reasons for caution in relying on the official projections.

Economic growth can suffer more interruption than assumed. My instincts give me confidence that the economy will perform well. Yet some of the next five years will probably produce lower rates of increase in GNP than assumed in the calculations. Deficits might then be larger by more than negligible amounts. I am not forecasting any major recession.

Expenditures will exceed OMB figures if only because Congress will not accept all of the President's recommendations. (Nor will all fees and other such increases incorporated in the budget proposals be approved.) Spending will almost certainly go up more than assumed. Despite the restraints in Gramm-Rudman-Hollings (GRH), and despite the talk about control, too many Americans have too strong a desire for the fruits of Federal spending for the fort to hold. Human ingenuity will find ways to get around restrictions. By how much? No one can know. But it seems to me unrealistic to act on the assumption that spending will be held to levels used in projections now before us.

The questions raised in the Chairman's letter of invitation have political as well as economic aspects. The former outweigh the latter, it seems to me; but I cannot limit comments to economic elements because political aspects are intertwined with everything. My observation of governmental processes has extended more than half a century since I began as a university student. Yet a member of Congress has far more knowledge of politics than an outside observer. And politics are crucial.

Rising Public Debt

Are there enough disadvantages to the growth of Federal debt to warrant sacrifices and unpleasantness now? Although the issues are more complex than recognized in typical public comment, a large and growing debt should cause concern. Yet the economy also gets larger Even big increases in the debt do not ensure a decline in the worth of the dollar (inflation). Witness the decline in inflation in the last few years. Nor does the need for huge borrowings (debt growth and refundings) inevitably raise the cost of borrowing (interest rates). Witness recent experience as interest rates have come down.

Nevertheless, the interest required does absorb tax and borrowing capacity. Would it not be welcome to have some of those funds for current services? And cumulative increase in debt can build to conditions with ominous prospects although such is not the immediate outlook. Still, much of the present debt is relatively short-term. Refundings always lie ahead. We, the debtors, could face appreciably higher interest bills if (short-term) interest rates were to go up to, say, the 10 percent range of not so long ago--compared with the 6.5 percent range assumed by OMB for 1987 or the 5.4 percent range assumed by CBO for 1991. The bigger the debt and faster its growth, the larger our vulnerability to rising interest rates. At the moment, rising inflation as a source of higher interest rates seems little cause for concern. But conditions can change.

How much American debt will foreigners finance in the years ahead? Perhaps this supply of funds will decline with some upward pressure on interest rates.

Some of us feel that we and others have an obligation to pay our way, to pay for what we get. What kind of a value system will support bequeathing to those who come later a rising bill for interest on debt incurred to pay for current services as against income-producing assets?*

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* The capital and depreciation aspects of Federal finances present complex issues of accounting. Suffice it to say that existing measures leave much to be desired. Human capital and research outlays, for example, present especially difficult problems. Accruals of unfunded pension obligations run into large amounts.

Deficits and Discipline

Incurring deficits deserves consideration for a reason different from the growth of debt as such. When people can spend "off the cuff" --off the other fellow's cuff!--will they not yield to the temptation to spend to indulge in selfish, near-term indulgences? To feel comfortable in getting without sacrificing? Tolerance for deficits helps to explain the growth of Federal spending.

If taxes must be paid to finance expenditures, then proposals will be subject to more demanding and more constructive examination than if borrowing is accepted and expected. In the massive totals of Federal finances today, the discipline of the balanced-budget rule might seem weak, almost remote. But it would force restraint. Its absence must lead to Federal spending on things not worth the cost.

Government spending in itself, whether paid for by taxes or borrowing, utilizes resources. Sometimes it is said, not incorrectly, that the spending is the real "tax." And, or course, revenues from taxes and fees--perhaps those to balance a budget--are not available for private use. A society with a high level of Federal spending and taxes to pay the entire bill will be different from the society with a budget balanced at an appreciably lower level.

A Tax Increase Now? No.

Would America benefit from a tax increase? I think not.

By "tax increase," I mean a yield above that of the present system. The CBO projects a revenue increase of $366 billion from the present system, i.e., 1991 over 1986, almost 50 percent and a 0.4 percent increase in the percentage of GNP. Does the country need more? I side with opponents of any substantial revenue increases.

Frequently we hear of the inevitability of higher taxes. The new budget projections will mute the arguments somewhat, but not remove the substance.

Thinking as a responsible economist, I recognize the merits of the case for a modest--perhaps 3 to 5 percent--boost in taxes to help pay for what our legislators will vote for us in spending. Moreover, trying to act responsibly as an economist, I must endorse the proposed Business Transfer Tax as a potential improvement in the tax structure.

The BTT would certainly be superior to the income tax as applied to businesses. Through the years I have dreamed of improvements in the Federal tax system that involve drastic reduction of the corporation income tax. Until that objective is realized, we should, I believe, continue to work for reform that would reduce burdens on productive enterprise. The BTT could be used to do so. It would raise revenue, potentially large amounts, with a minimum (per dollar of revenue) of adverse effects on the economy. It could be a major element of an improved tax structure.

Yet I see a convincing reason for holding back on any tax increase--the prospect of its leading to undesirable growth of spending. A BTT as a "money machine" would invite higher spending and bigger, but not necessarily better, government over the years.

Both political and economic considerations are involved. The political aspect grows out of the belief that funds available will be spent; debt reduction would be almost accidental and temporary. (This is not the nineteenth century when, with minor exceptions, Federal debts incurred during war were twice paid off, or the 1920s when budget surpluses reduced debt year after year.) Spending increases from present programs could take many forms.

Each of us can think of spending increases we would welcome. Some might benefit the general public. But could we really expect the political process--legislative, bureaucratic, judicial, and military--to lead to better use of resources than would result in free markets? How can one evaluate the results of Federal spending and compare them with the substantially unknowable effects of taxes or borrowing? The consequences would often, I fear but cannot by any means prove, be inferior in terms of human values than the results that would be produced by decisions in the market place.

Although Federal deficits are often attributed to tax reductions, Federal revenues have gone up enormously. Thirty years ago after a major tax reduction they were, at $75 billion, higher than ever before. Twenty years ago, shortly after another major tax rate reduction, they were $131 billion-- a new peak. Ten years ago they were more than twice ($298 billion) the figure of 10 years earlier. And the 1986 estimate is almost two and a half times that of 1976. Only once, the recession year of 1983, have revenues been down from the preceding year. The

1987 estimate of $850 billion far exceeds the $599 billion of 1981 before the tax changes of that year had significant effect.

The present deficit is certainly acting as a curb on the rise in spending. Some of the results are probably not very good. The deficit is a crude device. But perhaps for the present it serves better than would a tax increase. No one can know what would develop if government had more resources at its disposal. On balance I come out against a tax increase at this time.

Senator ROTH. Mr. Rahn, please proceed.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. RAHN. Thank you, Mr. Chairman. I think we have an unusual opportunity before us at this time. It's a result I think of the good policies of the Reagan administration and also some luck.

But we are looking forward to higher economic growth, particularly going to the fourth year of recovery, than we have seen surely in the last 15 years.

Part of this brought about by the great drop in oil prices and we have done some analyses at the U.S. Chamber of Commerce on the impact of the oil price drop, and we have concluded that for every $10 a barrel drop you have in oil prices, in the first year, you will see real GNP rise by about 8 percent higher than it otherwise has been.

Senator ROTH. How much was that again?

Mr. RAHN. By 8 percent, and by the second year, you will have a compounding effect, too, by up to 1.6 percent higher than it would otherwise be.

In addition, the drop in the price of the dollar compared to our major competitors will cause an increased demand for United States goods and services abroad and particularly since oil prices are denominated in dollars a favorable impact of the falling dollar and the drop in oil prices is even stronger than the Europeans and the Japanese and Southeast Asians.

All of that will combine to breaking increased demand abroad for U.S. business services as, of course, the drop in interest rates have had.

Given that, we should see substantial economic growth. Unfortunately, we do have several problems. The problems are basically that caused by the U.S. Congress—the uncertainty about spending and taxes—and right now we see a very serious problem emerging because of a lack of agreement on an effective date for the tax reform proposals.

Businessmen are faced with enormous uncertainties. If you are trying to make a capital investment decision now and if you had little notion of the kind of depreciation you would be allowed, whether or not you're going to have an ITC, whether or not you would have salary depreciation, the number of years, whether or not it would be indexed, you would have a very difficult time making that kind of investment decision. We have done some informal sureys—of the members of the U.S. Chamber of Commerce and our board—that a high percentage of the investment decisions are being postponed. Of course, a business always has some necessary investment decisions it has to make for investments, but there are a number of investment decisions which are discretionary and which will depend very much on the effect of that treatment.

This has dragged on now for a good number of months. We have been lobbying the Congress and particularly the chairman of the Ways and Means Committee, the chairman of the Finance Committee, to come together to make a decision.

This is holding down economic growth. We see it in the report on plant equipment spending. You would expect plant equipment spending to be much higher, given the kind of economic growth that many private forecasters are now forecasting.

We could have 5 percent economic growth this year if we did not have this uncertainty. We have estimated we will probably have around 4 percent economic growth this year; we are in line with the OMB estimate.

But, even though that's a high rate of growth, a very unfortunate thing is that it could be far higher if Congress would straighten out the effective date for tax reform and also make a firm decision about bringing down spending.

Very quickly, our economic forecast is optimistic because of the drop in oil prices, the drop in value of the dollar, the drop in interest rates. We see a very good year on the price front.

The Consumer Price Index, we estimate, will only rise about 2.7 percent this year, and that's a phenomenal growth over where we have been.

The T bill rate probably will average around 6.5 percent or even less for the year. It's already down to 6.5 percent. What this means is that the kind of cut you need to make off the baseline projection for spending is far less than many people believe.

CBO is arguing the baseline deficit is about $181 billion; OMB says $182 billion. But if you take off about $1½ billion of the lower CPI, which seems quite certain at the moment of the big fall in interest rates, and if you take another $5.1 billion reduction off that because of the drop in interest rates, just the interest payments on the Federal debt, you come down with a baseline deficit protection of about $175 billion.

That means you have to cut spending by about $31 billion to meet Gramm-Rudman targets which we have been enthusiastically behind.

The question is how do you meet those targets?

Let me just give a very quick menu. If you did a COLA freeze, which we think is long overdue, you would save $7 billion there. If you gave a partial freeze, you would save somewhat less than that.

At least that's an area we ought to get into. Defense spending. The Defense Department now spends $11 billion a year on oil. When they were projecting oil prices, they had $25 a barrel. Oil prices are roughly half that right at the moment, so the Defense Department ought to be able to spend $5 billion less without impairing its readiness.

We agree with virtually all of the domestic spending projections the President has made in terms of reductions. But even if you only took about three-fourths of those, it would be about $22 billion. If you put the user fees in the President has projected at $3.3 billion, sale of assets at $3.2 billion and reforms to the agri program, which will lead to lower prices, maybe about another $8 billion, that give you a protection of around $48 to $49 billion in spending growth rate reduction and you only need by our estimates $31 billion to meet Gramm-Rudman targets, roughly two-thirds.

So we see this as very do-able, even without the fallacious notion of increasing static revenues through tax increases. I think Mr. Roberts laid it out well, as did Mr. Miller.

First of all, a tax increase. We only need to look at history. First of all, we find Congress spends any tax increase. I think of TEFRA. We were promised $3 of spending growth reduction for every dollar tax increase. The truth of the matter is you got about $1.16 of spending growth rate increase for each dollar tax increase.

It won't impair economic growth. Mr. Roberts again explained that we have enormous empirical evidence of the destructive effects on economic growth of tax increases.

And if you put these two things together, it's very clear that a tax increase will increase deficit, because of the combination of the economic and political forces, and we strongly urge the Budget Committee to stay away from such a foolhardy course.

You have a great opportunity. The dozen years that I have been involved in political economy in this town, I have never seen a better opportunity for a sustained period of economic growth with less misery that we have right now, and I know you two are firm believers in economic growth, and I just hope you can convert the rest of your colleagues when we have this great window of opportunity.

Thank you very much, Mr. Chairman.

Senator ROTH. Thank you, Mr. Rahn.

[The prepared statement of Mr. Rahn, together with an attachment, follows:]

PREPARED STATEMENT OF RICHARD W. RAHN

I am Richard W. Rahn, Vice-President and Chief Economist of the U.S. Chamber of Commerce. We are pleased to have the opportunity to comment on the budget and economic outlook and to share with you our recommendations to achieve the mandated Gramm-Rudman-Hollings deficit targets without raising taxes.

Summary

The chief cause of today's federal budget deficits is the relentless growth of federal spending. Congress' past difficulties in solving this problem led to the recent passage of the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985. The solution to meeting the mandates of the Gramm-Rudman-Hollings Act is to impose firm limits on the growth in federal spending and to pursue policies that lead to high economic growth. Tax increases will be ineffective and counterproductive in meeting the mandates of the Act and may slow economic growth.

The overriding objective of fiscal policy should be to enhance economic growth. The engine of economic growth provides all Americans the opportunity to work, to achieve higher standards-of-living and to look to the future with optimism and hope. The strength of America lay in the people, not in the size of the federal government. All of the government job programs of recent years, for example, pale into insignificance compared to what the current economic recovery has done to help Americans find jobs. Since 1982, 10.4 million new jobs have been created, bringing our current work force to 109 million, the highest in our history.

To some extent, large and uncontrolled federal budget deficits threaten continued economic growth by "crowding out" private borrowers in the credit markets and by increasing the portion of the federal spending dedicated to paying interest on the national debt. But deficits, per se, are not the cause of our economic difficulties. Federal deficits are a symptom of an even larger problem: uncontrolled federal spending. Rising levels of federal spending damage the economy in two ways. First, federal spending "crowds out" scarce resources that could otherwise be used for productivity-enhancing investment in the private sector. Second, rising levels of taxation required to finance rising expenditures produce disincentive effects on investment and employment.

Since 1980, the real growth of federal spending has averaged 3.9 percent annually, much more than the real growth of the economy, which averaged 2.3 percent. From 1980 to 1985, tax revenues have increased by $217 billion, an increase of 42 percent. However, from

1980 to 1985, federal spending has risen $355 billion, an increase of over 60 percent. As a consequence, this explosive growth in federal spending, the budget deficit has risen from $72 billion in 1980 to $221 billion in 1985. Clearly, the solution to reducing the deficit is to reduce federal spending.

Recent economic and budget trends reinforce this view. The oil price drop, lower interest rates and more favorable exchange rates will contribute to higher economic growth and a lower deficit than was originally forecast. Congress will find reducing federal spending a more manageable task for FY' 87 and beyond, thereby sparring the American people from a burdensome tax increase.

I. Opportunities to Reduce Spending Growth and Cut the Deficit

The Gramm-Rudman-Hollings Act forces Congress to confront the issue of reducing the growth of federal spending. We believe that Congress must thoroughly examine every portion of the federal budget in order to find potential savings. Reputable sources, such as the Congressional Budget Office (CBO), the General Accounting Office (GAO), the Office of Management and Budget (OMB), the Heritage Foundation, the Brookings Institute and the Grace Commission have documented spending reduction opportunities that easily exceed $100 billion in potential savings in one year alone.

We strongly encourage Congress to take advantage of the numerous spending reduction proposals put forward by these organizations. Both CBO and OMB estimate that the FY '87 deficit will be less than $40 billion over the target deficit of $144 billion. Considering that fact that the federal government spends over $1 trillion a year, this is not an exceptionally large amount of budget savings to accomplish in one year.

In the effort to reduce federal spending by $40 billion, Congress must consider restraints on entitlement spending. Spending for entitlement programs like Social Security and Medicare have accounted for a large portion of spending growth in recent years. For example, from 1980 to the end of this fiscal year, medicare outlays will have increased 100 percent and Social Security outlays will have increased 80 percent. Consequently, it is important that Congress implement such reforms as COLA (cost-of-living) freezes in federal pension and social security programs, and higher co-payments and fees for Medicare beneficiaries. Substantive reform is warranted in light of the large subsidies given to present retirees under today's Social Security system and federal pension systems. Future generations will confront billions of dollars of unfunded liabilities, and will receive a poor return on their contributions to such programs. For example, according to a recent estimate by the Congressional Research Service, today's 20-year-old will receive 72 cents for every dollar he puts into the Social Security system.

In the nondefense discretionary area, substantial savings can be made in hundreds of programs ranging from Amtrak to the Rural Electrification Administration. Special attention should also be given to reducing the cost of price supports for agriculture.

Congress should continue to seek efficiencies within the Department of Defense. Base closures, pay reform, contract efficiencies, greater use of contracting out, and other cost savings should be pursued. Numerous studies by the President's Private Sector Survey of Cost Control, GAO, and CBO have discovered many areas within the Department of Defense where substantial cost savings could be achieved without jeopardizing our national security. We encourage you to continue to review these many proposals and urge their adoption where appropriate. Further, Congress should review the Packard Commission's recommendations to stretch the defense dollar.

Congress should also take advantage of an exciting and relatively novel method to achieve spending reduction - privatization. The essential idea behind privatization is to identify those government services that could be more efficiently provided by the private sector. There are three major variations on the privatization theme: asset sales, contracting-out and vouchers. The general rationale behind privatization is to utilize the superior efficiency of the private sector and the competitive pressures of the marketplace to produce such services at the least cost possible.

Although Americans are only recently becoming interested in the issue, the trend toward privatization is a world-wide phenomenon and some countries, notably Great Britain are way ahead of us. Great Britain has realized more than $27 billion through privatization over the past several years and expects to obtain another $20 billion in the next three years.

II. Favorable Economic and Budget Outlook Leads to Declining Deficits

The combination of robust economic growth for this year and recent restraints on federal spending have created an environment conducive to full implementation of the Gramm-Rudman-Hollings deficit targets without raising taxes. In 1985, OMB and CBO put forth preliminary estimates of the FY '87 deficit indicating that $60 to $70 billion dollars in deficit reduction would be required to comply with the G-R-H deficit limit. It was our contention that this magnitude of deficit reduction was achievable in light of billions in documented savings mentioned earlier. However, the strong possibility of high economic growth for 1986 and 1987 will put deficits on a declining path, thus making it much easier to reach the G-R-H targets without tax increases.

o The Economic Outlook

Our optimistic outlook for the U.S. economy is based on the convergence of two events: the continued decline in the value of the U.S. dollar and the collapse of oil prices. To be sure, both of these occurrences have advantages and disadvantages. For example, while the dollar's strength during much of this decade wreaked havoc with our exporting industries, it also contributed to the declaration in the rate of growth in consumer prices. Similarly, while the inflationary shocks resulting from the 1973 and 1979 increases in oil prices dampened economic activity worldwide, it was certainly a boon for the domestic oil regions. Despite the pluses and minuses associated with these two events, we believe, that their combination this time around will translate into a net plus for the U.S. economy.

After studying the issue of falling oil prices extensively, we have concluded that despite the negative impact on the domestic oil industry, the decline in oil prices is a welcome shot in the arm for the U.S. economy as a whole. Table 1 in the attachment shows the results of our econometric analysis of the impact on the U.S. economy of a $10 per barrel drop in the price of oil. A sustained $10 drop raises real GNP by 0.8 percent in the first year and 1.6 percent in the second year compared to what would otherwise have been the case. In terms of growth rates, this means that the oil price decline adds 1.2 percentage points to real GNP growth in 1986 and 1.0 percentage points in 1987.

The impact on the real economy is due to the significant improvement in the outlook for inflation that results from the drop in oil prices. Our analysis shows that the rate of growth of the consumer price index will decline by 1.1 percentage points in 1986 and 0.3 percentage points in 1987. Lower inflation, and reduced expectations of future inflation, will contribute to lower interest rates.

The combination of lower energy costs and lower rates of interest will spur investment, both in the residential and nonresidential sectors. As a consequence, nonresidential investment should be 1.3 percent higher in 1986 and three percent higher in 1987 than would other have been the case. Similarly, residential investment is anticipated to rise by 2.1 percent and 4.1 percent respectively.

Higher levels of investment mean that more private sector jobs are created. As a result, civilian employment is 0.4 percent higher in 1986 and 0.9 percent higher in 1987 than would otherwise have been the case.

Lower prices and higher employment raise real disposable income and consumer purchasing power. Consequently, consumer spending will be 0.8 percent higher in 1986 and 1.4 percent higher in 1987 that would have been the case without the oil price reduction.

The dollar depreciation affects the national economy by changing the prices of imports and exports. That is, a lower valued dollar reduces the foreign currency value of our exports, improving their competitiveness and raising foreign demand for our goods and services. At the same time, the dollar value of imported goods rises because, as the dollar depreciates, it can be exchanged for fewer yen, for instance. The effect is to increase U.S. exports and reduce imports, thus improving our trade balance and boosting national output, income and employment.

In spite of the fact that the National Income Accounts have not yet reported a turnaround in the trade balance, there are some signs of improvement in the industrial sector which can be traced to the dollar's decline. As foreign competitors begin to raise their prices, American firms are winning more orders at home as well as abroad.

In the short run, concerns about sharply accelerating inflation due to the dollar's decline have been rendered moot by the offsetting effect on domestic prices of the decline in oil prices. Our forecast assumes that the price of imported oil averages $14 per barrel while the dollar is anticipated to drop by 11 percent. The combination of a declining dollar and oil prices will result in a net plus for the American economy.

Our optimistic outlook must be tempered by the final outcome of the tax reform debate. A successful tax reform package must enhance the economy's potential through substantially lower marginal tax rates, strong incentives for capital formation, and a date certain for enactment, preferably January 1, 1987. The House-passed tax reform package -- H.R. 3838 -- is having a significantly negative impact on business investment. Congress and the Administration will not decide on, and make public, a definite effective date for tax reform. The lack of commitment from our nation's leaders has propelled the business community into a virtual twilight zone of uncertainty -- a land where business investment in plant and equipment hangs in suspended animation -- delayed or even cancelled due to uncertainty about the impeding tax reform an the date when it will become effective.

If Congress and the Administration do not get their act together, the lack of an effective date could slow economic growth this year as capital investment stagnates.

o The Budget Outlook

The favorable economic outlook mentioned above bodes well for deficit reduction this year and next. Higher GNP growth means higher tax revenues. Higher employment means lower spending for low income support programs. Lower inflation means lower costs for government purchases and lower cost-of-living adjustments. Lower interest rates means lower outlays for interest charges. In addition, recent policy decisions have slowed the explosive growth in federal spending.

The recent CBO and OMB baseline estimates are reasonable assessments of future budget and economic events. They take into consideration a number of favorable factors that have developed in the recent past. Lower defense spending contained in last year's budget resolution, lower non-defense spending as a result of last year's budget resolution, lower net interest charges and other outlay changes all contribute to the more favorable deficit forecast for 1987. In addition, the 1986 Gramm-Rudman-Hollings sequester of $11.7 billion automatically reduces future spending by lowering the spending base in the out-years. The precise estimates of the out-years savings are difficult to determine. Some preliminary estimates indicate that the $11.7 billion sequester could translate outlays savings of $18 billion in FY '87, $22 billion in FY '88 and $23 billion in FY '89 and '90.

In addition to these effects, there are a variety of favorable developments that CBO and OMB did not take into consideration. These factors could lead to an even lower deficit or, at least, mitigate the effects of future negative events. For example, CBO assumes that the T-bill interest rate will fall from 7.5 percent to 6.8 percent over the course of 1986. However, the T-bill rate has already fallen to 6.55 percent and this has been mirrored in a comparable fall in long term interest rates. OMB calculates that a sustained 1 percent drop of interest rates will lead to a one year deficit reduction of $5.1 billion.

Furthermore, both the CBO and OMB baseline forecasts assume $25 a barrel oil and that high oil prices will continue through the out-years, thus ignoring the large drop in oil prices we have experienced. The enormous stimulus of the $15 per barrel oil price drop we have already had is the equivalent of a $50 to $75 billion tax cut. As we mentioned earlier, we forecast real GNP growth to be 1.2 percentage points higher in 1986 and 1.0 percentage point higher in 1987. Recent data on FY '86 tax revenues indicate that revenues are running about $8 to $10 billion higher than was originally forecast by CBO and OMB. This would revise the entire revenue base upward, and substantially lower the out-years deficits. In addition, the 1.0 percent higher GNP growth forecast for 1987 would add another $6.2 billion in revenue to the higher revenue base.

As a consequence of the favorable budget and economic outlook, we believe that it would be wise to take advantage of the situation by reducing federal spending and refraining from tax increases.

III. Tax Increases: Prescription for Stagnation

There is no easier way to derail the economic recovery we are presently enjoying than to raise taxes. A tax increase would slow investment, harm productivity, impede international competitiveness, reduce the American standard of living and throw millions of people out of work. A tax increase will not even reduce the deficit.

A tax increase is a bad idea. It is a bad idea that does not want to die. But it deserves to be put out of its misery. Let me explain.

The basic prerequisite for a strong and growing economy is limited taxation. Studies by the World Bank and the Organization for Economic Cooperation and Development (OECD) indicate that those countries with high rates of economic growth have low tax rates and those with a persistent pattern of stagnation have high taxes and burdensome government. Countries that continue to grow and enrich their populations have economic systems that reward work, enterprise, and creativity. But these incentives cannot be maintained with a budget policy that feeds runaway spending by burdening workers and businesses with rising levels of taxation.

The European experience in the late 70's and early 80's raises serious doubts about the use of taxation as a method of solving fiscal problems. As government expenditures escalated throughout the 1970's, the clamor for fiscal responsibility also rose and all the major European industrial countries raised taxes. Taxes as a percentage of Gross Domestic Product (GDP) in OECD Europe stood at 32.7 percent in 1962; by 1982, they had soared to 45.7 percent. And the result? Rather than decreasing, European deficits have soared along with taxes. Revenues and expenditures were in balance in 1962, but by 1982 the European deficit was in excess of 5 percent of GDP.

The fact that rising levels of taxation is associated with rising deficits indicates the importance of the incentive, or supply-side, effects of taxation. Rising tax rates have reduced the reward to labor and capital and have increased incentives to resort to tax shelters and the underground economy. The effects of higher taxes -- reduction in economic growth and a decrease in the tax base -- are especially pronounced in many high-tax countries.

The European experience brings home the fact that the true measure of the public sector's burden is not its budget deficit, but the percentage of national output it takes. The only meaningful way to restore and sustain economic growth is to reduce both taxation and government spending.

Despite the well-established negative effects of higher taxation, many in Congress still clamor for more revenue as part of the solution to the deficit. In fact, the Senate Budget Committee is currently considering raising between $12 to $20 billion in new taxes as part of a budget plan to meet the Gramm-Rudman-Hollings FY '87 deficit target.

There are, naturally, several different ways to increase taxes. Tax rates could be raised. This would be particularly likely if tax rates had been previously lowered as a result of tax reform. Taxes could be raised by base-broadening. Although some base-broadening initiatives are constructive, the base-broadening that raises the most revenue is repeal of the investment credit and accelerated cost recovery. The ITC and ACRS reduce the tax bias against investment and therefore are among the most economically constructive provisions in the tax code. Other much talked about revenue raisers are an oil import tax -- a tax that would have the same adverse economic effects that OPEC's high energy prices have had -- and a Value Added Tax or Business Transfer Tax.

o Oil Import Fee and Gasoline Taxes

Admittedly, there is a certain attraction to such a tax now that oil prices have fallen so sharply. For some, such a tax is viewed as "costless," since it could be structured so that oil and gas prices remain at last year's level. To adopt such a tax, however, would deny the economy an important source of stimulus for this year and beyond. The Chamber's Economic Policy Division has performed an extensive analysis of the economic effects of an oil import fee which is detailed in the Chamber's March 14 statement before the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance. The March 14 statement is provided as an attachment to this testimony.

An additional and compelling argument against oil and gas taxes is that they would deprive all Americans of a benefit they deserve. For over a decade, Americans have been paying the inflationary and other costs of a cartel-imposed price on oil. In addition, billions have been spent on energy conservation. After all these sacrifices, Americans deserve the benefits of falling oil and gas prices. They have earned them. Let's not deprive them of their just rewards.

- o Reducing tax expenditures across-the-board

Senator Chaffee proposes in S. 556 to disallow 10 percent of all tax expenditures. Tax expenditures are provisions in the tax code that reduce revenues (in a static sense) and are not viewed as part of a "normal" tax system. Normal, of course, is in the eye of the beholder. The Chaffee bill views accelerated cost recovery and reduced capital gains rates as departures from a "normal" tax and therefore would tax capital investment and capital gains at substantially higher rates than present law. This would simply exacerbate the existing tax bias against savings and investment and lead a reduced investment and lower rates of economic growth.

If used as a revenue raising device, the Chaffee bill would even forgo the advantages of lower tax rates found in the House Tax reform bill. Thus, the Chaffee bill, used as a revenue raiser, would contain the anti-growth provisions of the House bill without proferring pro-growth tax rate reductions.

o Value-Added Tax

The VAT has some politically attractive features which could prove irresistible to Congress. The VAT is a tax that is added on at each stage of the manufacturing process. This distinguishes it from a sales tax, which appears at the retail level. Such a hidden tax is politically attractive, as consumers are not aware of how much tax they are paying. It makes it much easier to raise the rate without public opposition.

Because the VAT is levied on a very broad base, incremental increases in the rate raises large amounts of revenue, a decided advantage for our elected representatives. Once the administrative apparatus is in place, it is easy to raise the rate with little additional political and financial cost. Many are concerned that a VAT would soon be discovered by Congress as an easy vehicle for solving the budget deficit problem without having to raise highly-visible taxes or reducing government spending.

Since many European countries do employ a VAT, some have suggested that it would be to the United State's trade advantage to adopt one. Since the tax is levied on imports and not exports, it is sometimes recommended as a less-harmful revenue raiser that would offset import taxes paid by the U.S. on the products it exports to other countries.

The current income tax system encourages consumption by raising the cost of saving and investing. A consumption-type tax like a VAT, however, removes the bias toward consumption, leaving the choice between savings, investment and consumption neutral.

Although most Western European countries employ VATs, the U.S. has previously avoided such a tax because of many perceived disadvantages and criticisms.

In summary, we must realize that massive tax increases will not reduce the deficit and may even worsen it by diminishing economic growth. All too often, the logic behind a tax increase is based on a faulty accounting perspective of tax revenue. The argument is that tax revenues expand by the increase in the tax rate multiplied by the existing tax base. However, this static estimate of tax revenues fails to take into consideration the disincentive effects of higher tax rates upon the tax base. Specifically, rising tax rates mean less economic growth, less income and profits, and less tax revenue. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) illustrates this point. In conjunction with modest decreases in some spending, TEFRA, when enacted, promised a $103.9 billion deficit in FY '83 and an $83.9 billion deficit in FY '84. These targets, of course, were never achieved because revenues failed to rise and actual spending exceeded targets by a substantial margin. The FY '83 deficit was $207.7 billion and the FY '84 deficit was $185.3 billion. Not only did he deficit fail to decline; it more than doubled from what had been projected. The lesson from TEFRA is that rising taxes encourage more not less government spending. More taxes are a signal to special interest groups that more money is available for spending, thereby reducing fiscal discipline.

Conclusion

As a result of the favorable economic outlook and recent policy decisions to restrain spending, federal deficits are on a declining path. Consequently, the Gramm-Rudman-Hollings targets can be easily achieved through spending reductions alone. Given the favorable macroeconomic environment, Congress has a historic opportunity to set the economy on a new wave of high economic growth by reducing federal spending and enacting a pro-growth tax reform package.

Attachment

STATEMENT
on
LEGISLATIVE PROPOSALS FOR A TAX ON IMPORTED OIL
for submission to the
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
of the
SENATE COMMITTEE ON FINANCE
by
Susan L. Connolly*
March 14, 1986

The U.S. Chamber of Commerce is pleased to have the opportunity to comment as the Committee considers legislative proposals for a tax on imported oil.

The Chamber strongly opposes any new energy production or use taxes, including an oil import fee or increased federal tax on gasoline. This position has been reviewed twice by the Chamber's Board of Directors during the past four months. Each time the Board voted to oppose such taxes.

It urges opposition to S. 1997, introduced by Senators Wallop and Bentsen, to establish a $22 per barrel floor price for the imposition of a tax on imported oil; S. 1507, introduced by Senator Boren, to levy a $5 per barrel tax on imported crude oil and a $10 per barrel tax on refined petroleum products; and any other energy tax proposals offered as a means of reducing the federal deficit, keeping the tax reform bill "revenue neutral," shoring up the price of domestic oil, promoting energy independence, or other purposes.

The Chamber believes an oil import fee, such as those called for in the Wallop/Bensten and Boren proposals, would deny Americans much of the economic benefit resulting from declining oil prices. While an oil import tax would raise revenues, we caution that the actual revenues to the federal Treasury would be less than the static revenue estimates indicate. Further, an oil import tax would be discriminatory and regressive, hurt the overall economy, create competitive imbalances, and penalize our allies. Our reasons for these conclusions are elaborated in the following three sections.

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*Manager, Energy and Natural Resources Policy, Resources Policy Department

(1) Economic Benefits of an Oil Price Decline

Econometric studies generally agree that a decline in the price of oil would have a positive effect on our nation's economy by lowering inflation and interest rates and, thus, spuring economic growth and reducing unemployment.

Chamber economists examined the probable effects of an arbitrary $10 per barrel drop in oil prices. The results are listed in Table 1. Generally, they found it would provide the following benefits to the American economy:

A Drop in Oil Prices Raises GNP and Lowers Inflation. A sustained $10 per barrel drop in oil prices would raise the level of real GNP by 0.8 percent in the first year and 1.6 percent in the second year compared to what otherwise would have been the case. (See Figure 1.) In terms of growth rates, this means that a $10 per barrel decline in the price of oil would add 1.2 percentage points to real GNP growth in the first year and 1.0 percentage points in the second.

As a result of recent oil price decreases, we can expect real GNP to be 1.2 percentage points higher in 1986 and 1.0 percentage point higher in 1987 than would otherwise have been the case. Using the December 1985* Blue Chip consensus forecast of 2.5 percent growth in 1986 and 3.1 percent growth in 1987 as a starting point, this means that on the basis of the oil price decline that has already occurred, we can expect real GNP growth to be 3.7 percent this year and 4.1 percent in 1987.

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*The rationale for using the December 1985 consensus forecast rather than the latest one is that the former probably did not anticipate as rapid a decline in oil prices as has actually occurred.

The drop in oil prices would lower inflation. A $10 per barrel decline in oil prices would lower the rate of growth of the consumer price index by 1.1 percentage points in the first year. Any fall in oil prices is particularly good news to consumers as it cuts their energy bills.

Reduced Inflation Leads to Lower Interest Rates. Lower inflation rates are expected to lead to lower interest rates in 1986 and 1987. A $10 per barrel drop in oil prices should lower the rate on three-month Treasury bills by 30 basis points in 1986 and 20 basis points in 1987.

Lower Energy Costs and Lower Interest Rates Spur Investment. Lower energy costs and lower interest rates improve the outlook for both residential and nonresidential investment. A sustained $10 per barrel drop in oil prices should have the following effects: In 1986 and 1987, the level of nonresidential investment would be 1.3 percent and 3.0 percent higher, respectively, than otherwise would have been the case. Similarly, residential investment would be 2.1 percent higher in 1986 and 4.1 percent higher in 1987.

Increased Investment Creates More Jobs. Increased investment creates more private-sector jobs. As a result, civilian employment should be 0.4 percent higher in 1986 and 0.9 percent higher in 1987, than otherwise would have been the case. (See Figure 2.)

Lower Prices and Increased Employment Stimulate Consumer Spending. Lower prices and increased employment will raise real disposable income and consumer purchasing power. As a result, consumer spending will increase.

Chamber economists predict that the combination of stronger income growth and lower interest rates would reduce the budget deficit by a cumulative $20 billion over two years.

(2) Negative Effects on the Economy from an Oil Import Tax

Chamber economists also examined the economic impact of an oil import tax on the national economy. A simulation was performed by the consulting firm of Laurence H. Meyer & Associates (Table 2) based on an arbitrary $5 per barrel import tax. The static revenue increase from the tax is estimated to be $10.1 billion in 1986 and $10.8 billion in 1987. It is assumed that the Federal Reserve will realize that the rise in inflation is due to the import tax and not an upward trend in prices and, thus, provide additional reserves to maintain interest rates at approximately the same level as the base case. If the Federal Reserve did not accommodate the new tax, however, the negative effect on the economy, particularly on investment, would be larger.

The results of the simulation show that enactment of an import tax would lower overall economic activity and significantly increase inflation, partially offsetting the gains to the nation's economy stemming from the recent slide in oil prices. We believe these results offer compelling arguments against the imposition of an oil import tax.

An Oil Import Tax Lowers Real GNP, Increases Inflation and Lowers Consumer Spending. The level of real GNP would be 0.2 percent lower in 1986 (or $8 billion) and 0.5 percent lower in 1987 (or $17.3 billion) than otherwise would have been the case. This means that the rate of growth of real GNP would be 0.2 percentage points lower each year. (See Figure 3.) As a consequence of reduced economic activity and higher prices, real consumer spending would be 0.2 percent lower in 1986 (or $5.8 billion) and 0.4 percent lower in 1987 (or $10.5 billion) than otherwise would have been the case. Residential and nonresidential fixed investment would also suffer. Real nonresidential investment would fall 0.3 percent in 1986 (or $1.5 billion) and 0.7 percent in 1987 (or $3.7 billion). Real residential investment would fall by similar percentages.

Lower Investment Means Fewer Jobs Created. Lower investment means that fewer private-sector jobs are created. As a result, the oil import tax would cause civilian employment to fall by 0.1 percent and 0.3 percent in 1986 and 1987, respectively, compared to what would have been the case without the added tax. This implies a cumulative loss of 400,000 jobs in 1986 and 1987. The civilian unemployment rate would be 0.1 percentage point higher in 1986 and 0.2 percentage point higher in 1987. (See Figure 4.)

A new tax would reduce the size of the National Income Accounts (NIA) deficit. However, the dynamic reduction ($17.9 billion over the two years) is $3 billion less than the static revenue estimate ($20.9 billion over the two years). The deficit is not reduced as much as expected because lower levels of economic activity and higher unemployment raise federal expenditures and lower receipts. On the other hand, the increase in inflation that would result from the tax would offset part of the reduction in government receipts that would occur due to lower levels of economic activity.

(3) Additional Arguments Against an Oil Import Tax

In addition to the serious negative economic impact an oil import tax would have on the economy, an oil import tax should be opposed for the following important reasons:

--An oil import tax is not consistent with the U.S. policy of free trade. A sizeable portion of U.S. oil imports comes from neighbors and allies, such as Mexico, Canada, and the United Kingdom. A fee would harm them and might encourage retaliatory action.

—An oil import tax would lead to higher prices for all forms of energy: natural gas, coal, and electricity. The price of domestically produced oil would be bid up to the price of imported oil, including the fee, and the prices of other energy sources also would rise.

—An oil import tax would mean higher energy prices, which would increase domestic manufacturing costs, making it even more difficult for U.S. industries to compete overseas and at home. Foreign producers would retain their lower energy costs and be able to undercut American goods in the U.S. market. American exports would suffer and imports surge. Industries especially affected by an oil import tax would be basic metals, metalworking, machinery manufacturing, chemicals, agriculture. motor vehicles, and transportation.

--An oil import tax is regressive and would most severely penalize middle- and low-income consumers who spend a greater percentage of their income on transportation, food, utility bills, and other necessities.

—An oil import tax discriminates against regions of the country where automobiles are a necessity of life and where fuel oil is the prime source of home heating fuel.

—Foreign countries, some refiners, and certain consumer groups will undoubtedly seek exemptions from the tax. Such exemptions would lead to new bureaucratic entitlement programs that would offset much of the revenue the tax was supposed to raise.

—Consumers who suffered the skyrocketing energy prices during the 1970s as a result of excessive costs of cartel-controlled prices should not be required to support the price of domestic oil and indirectly other fuels for the benefit of a handful of those who benefited during the 1970s.

Conclusion

The Chamber believes that, while actions to protect the economy and national security against an overdependence on foreign-produced energy could warrant federal intervention in the marketplace, such intrusion is not warranted at this time and would be counterproductive to the economy. In addition, we believe that if and when a time arises that national security is threatened, an oil import fee would not be the appropriate solution.

Attempts to solve the budget deficit by requiring Americans to pay more taxes also are unwarranted. Instead, we urge Congress to work to reduce the growth in federal spending.

Table 1

ECONOMIC IMPACT OF A $10 PER BARREL DROP IN THE PRICE OF IMPORTED OIL

(Percentage difference from base unless otherwise indicated.)

	1986	1987
GNP	0.5	0.8
Real GNP	0.8	1.6
Consumption	0.8	1.4
Nonresidental Investment	1.3	3.0
Residential Investment	2.1	4.1
Civilian Employment	0.4	0.9
Consumer Prices (1)	-1.1	-0.3
Implicit GNP Deflator (1)	-0.4	-0.4
3-Month Treasury-Bill Rate (2)	-30.0	-20.0
Corporate Bond Rate (2)	-10.0	-20.0

Note: The base simulation is the current Laurence H. Meyer and Associates (LHM&A) forecast (BASE601). The price of OPEC oil is $20 per barrel in both 1986 and 1987. The alternative simulation assumes that OPEC oil averages $10 per barrel in both 1986 and 1987.

(1) Percentage point difference.
(2) Basis point difference.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University (LHM&A) model of the U.S. economy.

February, 1986

Table 2

ECONOMIC IMPACT OF A $5 PER BARREL OIL IMPORT FEE

(Percentage difference from base unless otherwise indicated.)

	1986	1987
Real GNP	-0.2	-0.5
Consumption	-0.2	-0.4
Nonresidental Investment	-0.3	-0.7
Residential Investment	-0.4	-0.7
Civilian Employment	-0.1	-0.3
Civilian Unemployment Rate (1)	+0.1	+0.2
Consumer Prices (1)	+0.6	+0.2
Implicit GNP Deflator (1)	+0.5	+0.2

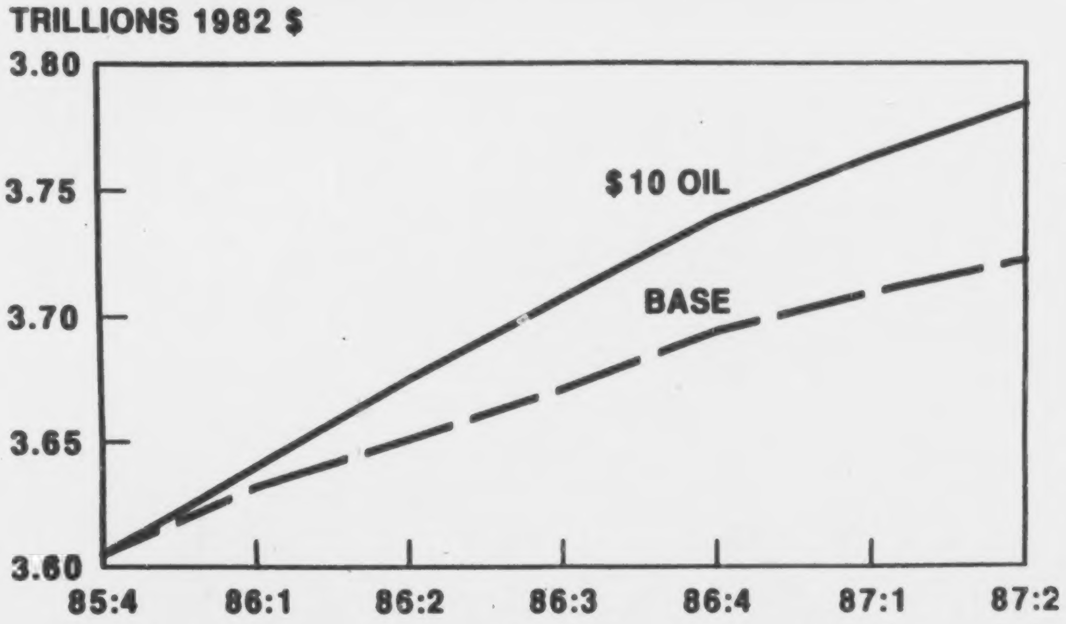
(1) Percentage point difference.

Source: Laurence H. Meyer and Associates, from a special analysis prepared for LHM&A clients.

February, 1986

Figure 1

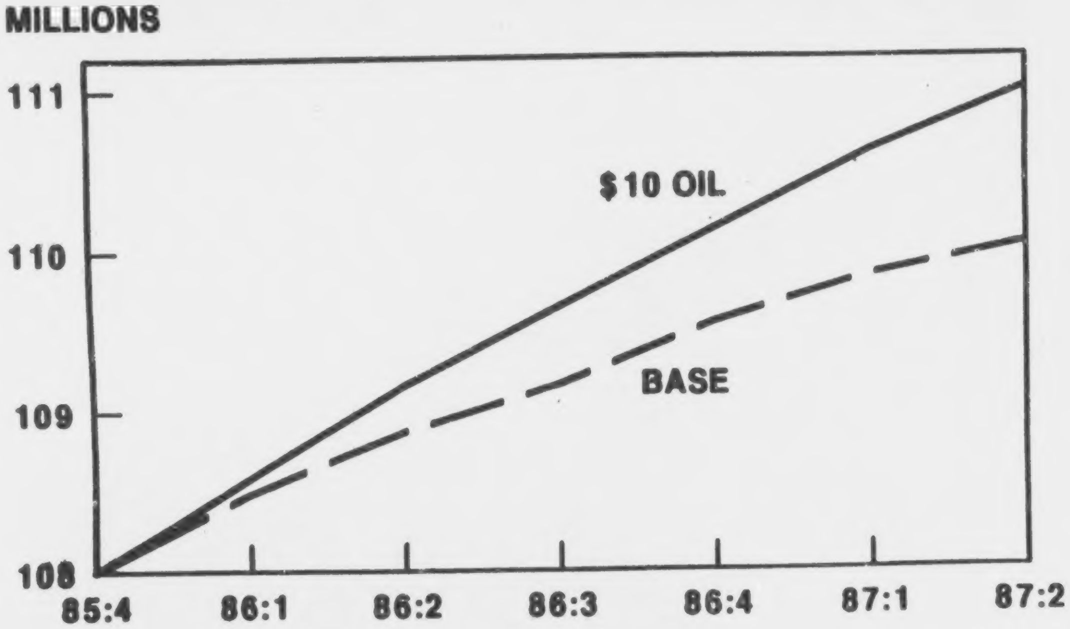
IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON REAL GNP



Source: U.S. Chamber of Commerce
February, 1986

Figure 2

IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON CIVILIAN EMPLOYMENT



Source: U.S. Chamber of Commerce
February, 1986

Figure 3

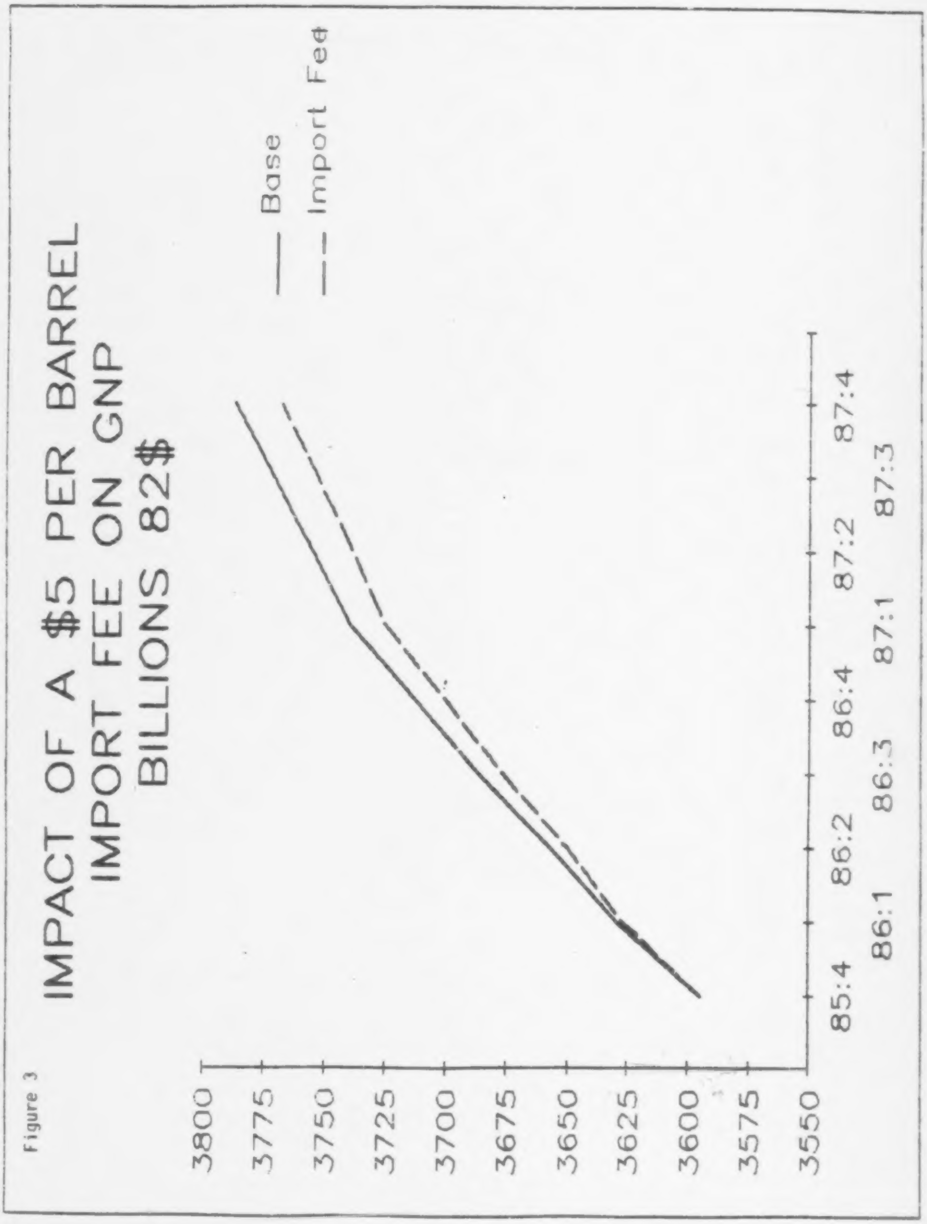
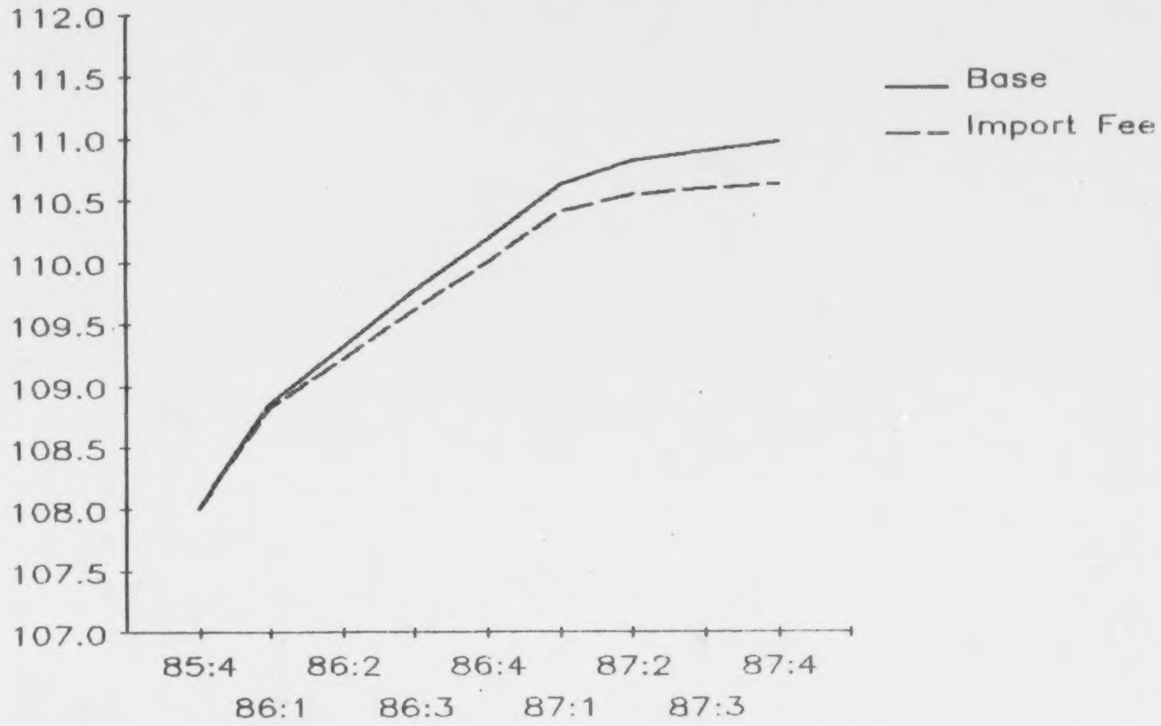

IMPACT OF A $5 PER BARREL
IMPORT FEE ON GNP
BILLIONS 82$
Base
Import Fee
3800
3775
3750
3725
3700
3675
3650
3625
3600
3575
3550
85:4
86:1
86:2
86:3
86:4
87:1
87:2
87:3
87:4

Figure 4

IMPACT OF A $5 PER BARREL IMPORT FEE ON EMPLOYMENT
MILLIONS



Senator ROTH. Mr. McKenzie, please proceed.

STATEMENT OF RICHARD B. McKENZIE, JOHN M. OLIN VISITING PROFESSOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO

Mr. McKENZIE. Mr. Chairman, my testimony is based on a much longer study that has been provided for the record as my prepared statement. If is being released this week by the Center for the Study of American Business at Washington University in St. Louis, where I am currently in residence. In that study, I seek to compare what the Government has done over the past few years with trends.

Basically, I compared the real expenditures in 1985 with the expenditures in 1981, and I compared the expenditures over the 1982–85 period with what would have been projected under a long-term expenditure trend established between 1967 and 1981 and the short-term trend established between 1978 and 1981. And it seems to me from that study, I came up with some interesting observations, if not a modern budget mythology.

Myth 1: Total Federal expenditures under the Reagan administration have been reduced.

The reality is that in fiscal 1985, the Federal Government spent in real 1972 dollars 18 percent more than it did in 1981, the last budget year of the Carter administration. Indeed, during the first 4 Reagan years, 1982 to 1985, the Federal Government spent 7 percent more real dollars than would have been spent if the long-term fiscal trend in Federal spending established between 1967 and 1981 had continued through 1985.

Of course, many analysts think under the Carter Presidency Federal spending was out of control; however, the fiscal path followed during Reagan's first 4 budget years traversed virtually the same fiscal trail chartered during the Carter Presidency. In fact, the Federal Government in fiscal 1985 spent, in real dollars, 1.1 percent more than would have been spent if the Carter budget trend had been continued through 1985.

Indeed, between 1982 and 1985, the Reagan administration managed to spend only one-tenth of 1 percent less than would have been spent if the Carter trend had continued during the period.

Myth 2: The Federal Government has begun to take a smaller share of gross national product under Reagan.

Contrary to popular belief, total Federal outlay as a percentage of GNP was nearly 1 percentage point higher in 1985 than 1981, and also 1 percentage point higher than 1985 than would have been projected for 1985 under the long-term 1967–81 trend. All that Washington political structure can claim is that the growth in the expenditure ratio has been slowed from the Carter trend, which was upward at one-half percent per year and has been returned, perhaps, to its long-term trend, which is upward at one-tenth of 1 percent per year.

Myth 3: Because of the growth in defense spending under the Reagan administration, Federal human resource programs have been gutted.

Without question, national defense spending surged during the 1982–85 period, but defense spending was only about 12-percent above what would have been projected under Carter. The truth is that only the growth rate, not the level of spending on human resources, has been cut during the Reagan years.

The Federal Government actually spent 10 percent more real dollars on human resource programs in 1985 than in 1981. Granted, much of this spending increase was in Social Security, nevertheless, Federal expenditures on non-Social Security human resource programs was 7-percent higher in 1985 than 1981. And it is important to know that the reduction in the growth of Federal spending on non-Social Security, welfare programs, was actually begun under the Carter administration.

Still, in spite of all of the talk of welfare cuts, the Federal Government spent only 8 percent less on welfare programs in the entire 1982–85 period than would have been projected under the upward Carter trend, and I stress that the rate under Reagan is upward also.

Myth 4: Federal tax collections have fallen under the Reagan administration.

Contrary to what may be widely assumed, total Federal receipts were higher in real terms in 1985 than in 1981. Although they decreased in 1982, due to the recession and the 1981 tax-cut package, they were practically back to the longrun trend in 1985.

In fact, they were only one-half of 1-percent lower than what would have happened if the longrun trend had continued.

Myth 5: Changes in the IRS Tax Codes have reduced in the past and will reduce in the future, the real Federal tax burden.

As has been widely acknowledged in public policy circles, the level of expenditures, not taxes ultimately reflects the Government's claim on the Nation's resources. Changes in IRA rates and rules will, for the most part, redistribute the burden of Government and will only marginally affect that total burden.

As noted, Federal outlays, as a percentage of GNP—for the "average expenditure tax rate"—continues to rise, even under a President publicly committed to curbing the growth of Government. The rise in the average expenditure tax rate means that much economic growth continues to be stifled by the anticipation of higher taxes or a higher real tax burden in the future, and I point out that if the average tax rate is rising, the marginal tax rate must be rising and must be about the average.

Myth 6: Flat proposals, such as Treasury I and II and other recently announced proposals which offset reductions in marginal personal income tax rates with the elimination of tax loopholes and with excise and corporate tax increases will not be "revenue-neutral."

By expanding the tax base, the flat-tax proposals reduce the ability of taxpayers to avoid taxes and increase the Government's monopoly power over taxable income. Accordingly, because of the reduced ability of taxpayers to escape taxation, political leaders should be less concerned about hiking tax rates over time. Hence, without external checks on the ability of Government to spend and collect taxes—for example, the balanced budget-tax limitation—a flatter tax limit can be expected to lead to greater Government tax collections over time.

In addition, the substitution of corporate taxes and excise taxes for personal taxes will further disguise the real cost of Government in higher prices for goods and services and lower wages, as well as reduce investment. Reduction in the perceived cost of Government should lead to more Government expenditures and a higher expenditure tax rates, and the investment disincentives will decrease the country's income growth and increased need for higher IRS tax rates in the future.

So it appears that the Congress and the President have been more successful in getting the IRS out of the citizens' wallets then the Government off their backs. Most of the inordinately large projected Federal deficit are more a product of the inability or the unwillingness of Congress and the President to reduce the rate of growth in total spending than in real taxes.

Real tax reform must start with cuts in real spending.

Thank you.

Senator ROTH. Thank you, Mr. McKenzie.

I have a lot of sympathy for what you are saying.

[The prepared statement of Mr. McKenzie follows:]

PREPARED STATEMENT OF RICHARD B. McKENZIE

TAX INCREASES: IS THE PAST PROLOGUE TO THE FUTURE?

Testimony prepared for the Joint Economic Committee
Washington, D.C., March 18, 1986

President Ronald Reagan has expressed his committment to curbing the growth in the federal expenditures and taxes from the day he took the oath of office in 1981. Indeed, he has frequently claimed a measure of success in achieving these objectives. However, as his 1986 State of the Union Address made clear, he is convinced that the expanding federal deficit is the result of continuing expenditure increases, not tax reductions.

President Reagan's critics on the political right have been quick to stress his failures to materially reduce the federal spending and taxes. On the other hand, his critics on the political left have charged that his drive to slash federal spending has focused on programs designed to aid the poor, while the President's tax reductions have benefitted mainly the well-to-do.

Because of the conflicting claims, confusion abounds on the question, "What has actually happended to the federal budget and its major components during the Reagan presidency? Is a tax increase to reduce the federal deficit warranted, given the fiscal record of recent years?" This report

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attempts to provide some answers to these questions in simple, straightforward terms.[1]

While recognizing that federal budget totals depend on many considerations (not the least of which are the state of the economy and the political leanings of the Congress and White House), this report does not emphasize political economy issues. For example, it does not address the question, "What effect has President Reagan had on the budget, independent of other political and economic forces?"

But, in reality, the question answered in this study is the more interesting one for those of us who believe that the past is often prologue to the future. Both the President and Congress have learned a great deal about what changes the other is willing to see take place on fiscal issues. The actual experience from 1982 to 1985, compared with established trends, is likely to say more about changing budget patterns during the next several years than is the President's 1987 budget document.

The study examines changes in federal outlays and receipts during the 1982-1985 fiscal years against a variety of yardsticks:

1) Outlays and receipts in fiscal 1981.

2) Projected outlays and receipts for the 1982-1985 fiscal years based on continuation of long-term trends for the 1967-1981 fiscal years.

3) Projected outlays and receipts for the 1982-1985 fiscal years based on continuation of short-term trends from the 1978-1981 period (the Carter years).

A brief summary of findings are outlined below with the intent of assessing the need for and consequences of a tax increase to reduce the federal deficit. A detailed discussion of the findings, along with graphs and a table of actual budget figures and computed long- and short-run trends, follow in the appendix.

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[1] All figures reported are in constant 1972 dollar terms. All current dollar outlays and receipts were adjusted by the GNP deflator.

TRENDS IN TOTAL FEDERAL OUTLAYS

While President Reagan has been committed to getting the "government off people's backs," he and the Congress clearly have not done so in terms of total federal outlays. The federal government spent 18 percent more in real dollars in fiscal 1985 than it spent in fiscal 1981, the last Carter budget year. Moreover, the increase in total outlays cannot be attributed solely to growth in population. In 1985, the federal government spent nearly 14 percent more in real per capita terms than it spent in 1981.

Furthermore, federal spending in every year between 1982 and 1985 significantly exceeded the long-run budget trend established during the 1967-1981 period. Indeed, during the first four Reagan years, the federal government spent a total of 6.6 percent more than would have been spent under the projected long-run trend, which was rising.

Of course, many analysts think that during the Carter presidency, federal spending was out of control. And during the 1978-1981 period, spending rose in real terms by nearly 14 percent, a faster clip than the previous decade of rising budget levels. However, it is important to understand that the fiscal path followed during Reagan's first four budget years traversed practically the same trail chartered during the Carter presidency. In fact, the federal government in fiscal 1985 spent in real terms 1.1 percent more than would have been spent if the Carter trend had been continued through 1985.

In short, little was done to change the long-term growth in total government outlays in constant-dollar terms over the past four years.

As has been widely acknowledged in public policy circles, the level of expenditures ultimately reflect the government's claim on the nation's resources, or are the real tax the country has the bear. What is important to understand is that the average "expenditure tax rate" (or total federal outlays as a percent of GNP) was nearly 1 percentage point higher in 1985 than in 1981 and almost 1 percentage point higher in 1985 than would have been projected for 1985 under the long-run trend. All that the Washington political structure can claim is that the growth in the average expenditure tax has been slowed from the Carter trend and more or less has been returned to its upward long-run trend.[2]

TRENDS IN BUDGET ALLOCATIONS

Budget priorities, measured by the percentage allocation of federal dollars among programs, have changed, as they have during the first term of virtually every president.

The Defense Buildup

Many commentators appear to think that the recent growth in defense buildup is the sole source of our budget problems. Granted, real defense outlays were nearly 36 percent higher in 1985 than 1981, and defense spending increased slightly less than 60 percent more during the 1982-1985 period than it would have had the 1967-1981 trend continued.

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[2] Whether the "expenditure tax rate" will fall below the long-run trend or rise with it is difficult to say at this juncture. The expenditure tax rate was declining during the 1982-1985 fiscal years, but the decline may be heavily influenced by the recessions of the early 1980s, which had the effect of raising total outlays as a percentage of GNP.

However, the downward slide in defense spending (due to a significant extent to the country's disengagement from Vietnam) was actually reversed during the Carter years, and it is an open question just how much of a defense buildup we would have experienced even without Reagan in office. Had the Carter trend continued during the 1982-1985 fiscal years, defense outlays would still have been more than 40 percent above the long-run trend, meaning defense spending has been raised during the first four Reagan years by less than 12 percent above projected Carter defense budgets. The concern in Washington, of course, is over how much of annual defense expenditure result in mounting deficits, lower expenditures on other programs, and higher prices for defense hardware.[3]

Human Resource Expenditures

Contrary to popular belief, human-resource programs as a group have not been trampled, nor have they been reduced during the 1982-1985 period. Much of the increased human resource expendituress has been on Social Security. The federal government spent 7 percent more real dollars on non-Social Security programs in 1985 than 1981. Furthermore, federal spending on these programs was below the projected long-run trend for 1982-1985. But the projected Carter trend for 1982-1985 was also below long-run projections for the period.

In other words, it is not clear that the Reagan Administration has been all that successful in cutting social programs as a whole.

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[3] National defense outlays rose from 5.3 percent in 1981 to 6.3 percent in 1985.

What does seem increasingly clear is that if social and physical resource programs are being shortchanged (and expenditures on physical resources dropped precipitously during 1982-1985), it has been due to a substantial degree to the unwillingness and/or inability of Congress and the Administration to chip away at the Social Security budget. Social Security provides significant benefits to middle- and upper-income, as well as lower-income, citizens who did not pay for them and who, when they were working, did not vote to provide, from their own pockets, similar benefits to elderly people that went before them. The Social Security budget has continued its relentless upward trek, practically unaffected by the party affiliation of people in the White House or Congress.

Until the imbalance between the political influence of elderly well-off and the non-elderly poor is corrected, the justice of what Congress does to the social welfare budget in other areas, as well as the defense budget, will be suspect. The equity claims of tax reformers, who profess tax neutrality is their goal, will be looked upon with equal suspicion by the growing younger generation of taxpayers.

TRENDS IN FEDERAL RECEIPTS

Contrary to what may be widely assumed, total federal receipts were higher in real terms in 1985 than in 1981. Although they decreased in 1982 due to the recession and the 1981 tax cut package, they were practically back to the long-run trend in 1985 (only .5 percent lower than would have been collected had the long-run trend continued). Any decrease in the short-run trend in total receipts was probably as much a result of the decrease in the inflation rate from the double-digit range to the 4 percent range (and the slowing of "bracket creep") as it was to discretionary tax-rate cuts begun in 1982.

In summary, it appears clear that the Congress and the President have been far more successful in getting the Internal Revenue Service out of citizens' wallets than off their backs. Most of the inordinately large projected federal deficits is more a product of the inability or unwillingness of Congress and the President to reduce the rate of growth in real total spending than in real taxes.

PROPOSALS FOR TAX INCREASES

Washington is buzzing with talk of tax increases. We have heard a great deal about Treasury I and II and other more recent proposals for revenue enhancements. Yet, much of the public discussion is grossly misleading. This is because many commentaries on "tax increases" fail to acknowledge that the real burden imposed by the federal budget ultimately, in the long-run, comes from the expenditure side of the budget. This "expenditure tax" is one that has been on the rise for some time. The real burden of government is only marginally affected by what is done to the IRS code.[4]

To make the fiscal debate clear, it is imperative that our political leaders and the public realize that changes in the IRS tax code will mainly affect the distribution of the "expenditure tax." Tax code changes will affect the expenditure tax only to the extent that distributional shifts in the tax burden affect the health of the general economy and the willingness and ability of our political leaders to spend and absorb more or less of the nation's resources.

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[4] Tax revenues can be collected with varying degrees of efficiency. How efficient the tax collection process is will determine, along with how much government spends, the total burden of the federal government.

Reasonable reservations persist about the real intent of recent proposals to change the tax code. First, the political leaders in Washington have shown little or no capacity to reduce the expenditure tax; it is still moving upward, a record that speaks far more eloquently than the politicians about our fiscal future. The long-run average expenditure tax rate has been moving upward, which means that the marginal expenditure tax must be above the average and also on the rise. We have, in other words, reason to be suspicious of claims by those who seek a new tax system that has lower marginal tax rates and that is revenue neutral. I suspect that because of the long-run upward trend in the expenditure tax rate, people will continue to plan for a heavier tax burden in the future than they now have.

Second, an argument to lower and flatten marginal tax rates while increasing the tax base seemingly harbors the seeds of tax-rate increases. Without explicit constitutional restrictions on the power of government to tax (through, for example, the balanced-budget/tax-limitation amendment) in place, a broadened tax base offers the government more monopoly power to raise the rates over time. We have reason to expect any government short on revenue to use any newly acquired monopoly power over people's incomes at the earliest convenience.

Third, we can always expect our political leaders to raise revenues in ways that are as painless and disguised as possible. One such politically painless form of taxation is capital taxation through profits, which is often disquised in the form of higher prices and lower wages and dividends (that can be blamed on businesses). It is politically painless to the extent that future generations, who do not now have a vote, pay a part of the tax through reduced income flows. Because capital taxes reduce the perceived costs of government to the current voting generations, such taxes can induce marginally more current government spending and a higher average and marginal expenditure tax over the long run.

Fourth, a presumption in so much of the talk about tax reform is that the deficit emerges after political decisions on receipts and outlays have been made -- that deficits are politically neutral. This seems to be odd, given all the talk about federal deficits. It appears that one of the first questions asked in the Halls of Congress is, "How much deficit can we get by with?" And it appears that the projected deficits are, at least for the next election, out of line with politically acceptable levels.

Seen in the light of the politically acceptable deficit question, tax increases without expenditure reductions will be at best a partial solution to the deficit problem. Tax increases can bubble out into expenditure tax increases; they can reduce the pressure on Washington politics to get the federal deficit back into line with politically acceptable deficit levels.

Finally, long-term growth in the country must ultimately be founded on a long-term tax policy. In terms of the expenditure tax, that long-term policy must, bluntly speaking, be one of gradually higher future tax rates. Without some demonstration on the part of Congress and the Administration that they are seriously willing to cut the rate of growth in the expenditure tax, it is doubtful that any flat-tax reform will, over the long haul, provide the desired work, saving, and investment incentives that are so necessary for economic growth, job creation, and poverty relief. The potential benefits of tax reform will be neutralized because it will be construed, at best, as tax deferral.

CONCLUDING COMMENTS

Proponents of tax reform and revenue enhancements should recognize that a lot of people have been fooled in the past by much misleading Washington rhetoric about tax reform and reductions; they are not about to be fooled for much longer. The word is beginning to circulate that the real governmental drain on the private sector is caused by expenditures that have continued to mount. Real tax reform can begin with Congress and the President making the fiscal decisions on budget allocations that they would like dearly to shirk or avoid.

APPENDIX

The BODY of the report highlighted major changes in the federal expenditures and receipts over the 1982-1985 period. This section provides additional statistical details on which the conclusions were based. Graphs for the actual federal outlays by functions and federal receipts by sources, for the 1967-1985 period (along with long-run trend lines computed on the basis of 1967-1981 data and short-run trend lines computed on the basis of 1978-1981 data) are provided. Details on the dollar and percent changes in budget categories are also summarized in Table 1 at the end of the report.

Again, the major conclusions about the budget experience during the first four Reagan years are as follows:

* Total outlays in real-dollar terms and as a percent of gross national product expanded more rapidly than during the previous decade and a half (1967-1981). The upward trends, in other words, continue unabated.

* Real outlays for "human resources" expanded below but close to their long-term growth trend (mainly because of the continued expansion of Social Security outlays).

* Real outlays for human resources, excluding Social Security, increased during the Reagan years but were below the long-run (1967-1981) and short-run (1978-1981) trends.

* Outlays on physical resources dropped substantially during the Reagan years.[1]

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[1] "Physical resources" are such items as energy, natural and environmental resources, commerce and housing credit, transportation, and community and regional development programs.

* National defense outlays have increased rapidly but along a growth trajectory not far above from the turn-around trend begun during the Carter presidency.

* Total constant dollar federal receipts in 1985 were significantly higher than in 1981 and, in spite of the 1981 tax rate cut, close to the rising long-run trend. However, the short-run (Carter) upward trend in total receipts as a percent of GNP was reversed and was on a decline during the 1982-1985 period.

* Personal income tax receipts fell temporarily after the passage of the three-year Reagan tax cut (coincidint with a severe recession) but were close to their long-run trend by fiscal 1985.

* Corporate income tax receipts were on a slight declining trend during 1967-1981 period but plunged dramatically during the 1982-1985 fiscal years (again coinciding with a severe recession).

* The growth in federal deficits during the Reagan years was therefore the product of receipts rising less rapidly than expenditures.

REAL FEDERAL OUTLAYS

Total Outlays

Figures 1A and B depict the actual, long-term trend, and short--term values for real total federal outlays for the period 1967-1985 (as measured in 1972 dollars). Total federal outlays as a percent of Gross National Product (GNP) is presented in Figure 2A and B. In each figure labeled with an A, a trend line is estimated based on outlays for the 1967-1981 period and is projected forward for fiscal years

1982-1985. In each figure labeled with a B, the trend line is estimated based on outlays for the 1978-1981 period and projected forward.

[Figures 1A and B]

Observations:

1. As can be seen in Figure 1A, during the Reagan years real federal outlays were significantly above 1981 outlays. In 1985, the federal government spent, in constant (1972) dollar terms, 18 percent (or $62 billion) more than was actually spent in 1981. (Details on these and other actual and projected budget figures are in the summary table at the end of the report.)[2]

2. Real federal outlays in 1985 were also above the estimated long-run and short-run trend values. In 1985, real federal outlays were 9.4 percent (or $35 billion) more than would have been spent had the long-term expenditure trend continued through 1985. However, 1985 spending was only 1.1 percent (or $5 billion) more than would have been spent had the short-term trend established during the Carter Presidency continued through 1985. See Figure 1B.

3. Over the entire 1982-1985 period, the federal government spent 6.6 percent (or $94 billion) more than would have been spent under the long-run trend but slightly less than would have been spent under the short-run (Carter) trend -- .1 percent (or $2 billion) less.

4. As can be seen in Figure 2A, outlays as a percent of Gross National Product also continued to move irregularly upward during the Reagan years, from 22.9 percent of GNP in 1981 to a peak of 24.5

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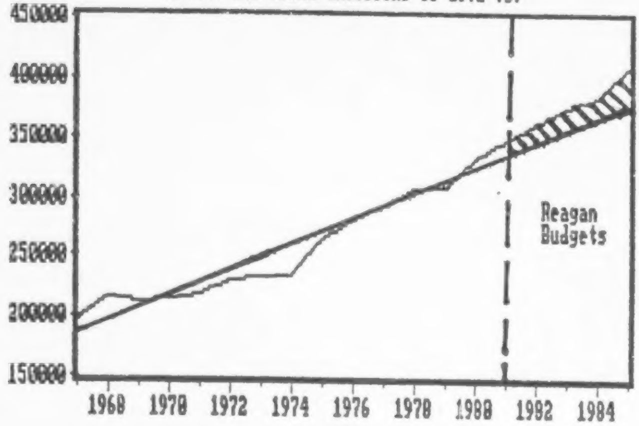
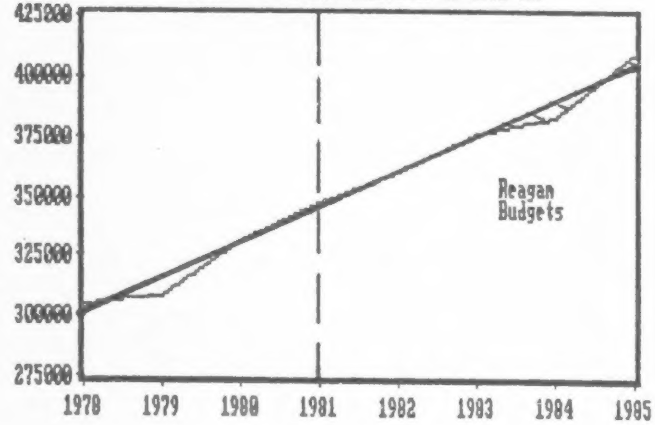
[2] In 1985, real federal outlays per capita ($1,713) were 13.7 percent higher than per capita outlays in 1981 and 7.2 percent higher than they would have been if the long-run trend had continued through 1985.

Figure 1A Real Total Federal Outlays, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 outlays

Figure 1B Real Total Federal Outlays, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 outlays

percent in 1983 and then back down to 23.7 percent in 1985.

[Figures 2A and B]

In every year between 1982 and 1985, federal outlays as a percentage of GNP was higher than the long-run trend. However, after 1983, projections of the short-run trend for federal outlays as a percent of GNP established during the Carter years were higher than the Reagan figures (see Figure 2B).

One disturbing aspect of Figure 2A is the long-term growth trend itself. This upward trend implies that the federal government continues to take a rising share of the nation's resources away from private sector uses. The overall average "expenditure tax" of the federal government has, in other words, continued to rise. While there are signs that the trend may have leveled off during the Reagan years, we cannot yet be certain that federal outlays as a percentage of GNP will not once again turn upward, as it has several times in the past.[3] The most definite conclusion that can be drawn is that the strong upward short-term trend of the Carter years has been tempered.

Human Resource Outlays

Figures 3A and B contain the actual and trend values for real outlays for "human resources," which include expenditures on Social Security, income security, education, health, Medicare, and veteran benefits. The actual and trend values for Social Security payments and non-Social Security outlays (i.e., human resource spending minus Social

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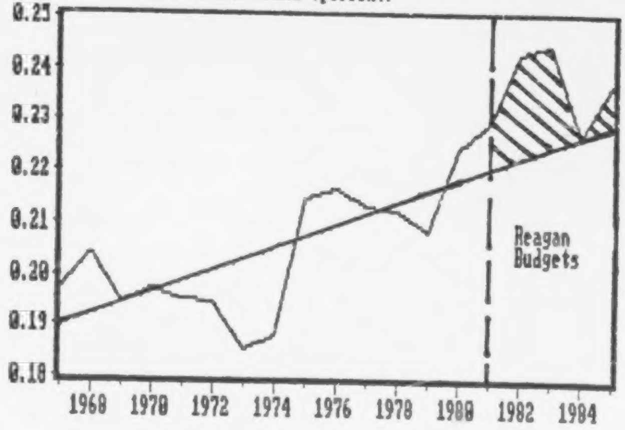
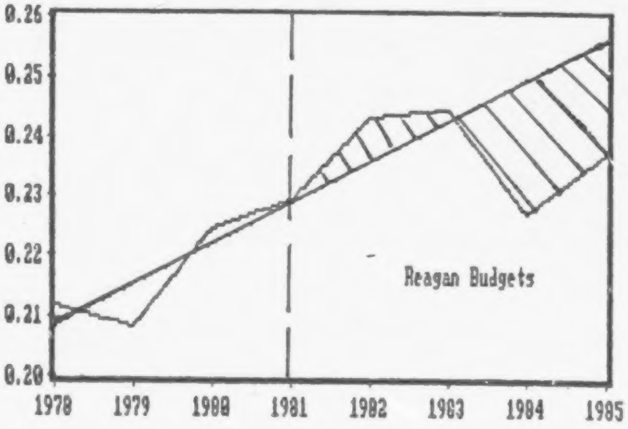
[3] Even if the average "expenditure tax" has leveled off, it has done so at a higher rate.

Figure 2A Total Federal Outlays as a Percent of GNP, 1967-1985
Actual and Trend (percent)



Note: Trend estimated on 1967-1981 percentages

Figure 2B Total Federal Outlays as a Percent of GNP, 1978-1985



Note: Trend estimated on 1978-1981 percentages

Security) are shown in Figures 4A and B.

[Figures 3A and B]

Observations:

Total Human Resource Spending

1. Total human resource outlays were below the long-run trend during every year of the 1982-1985 period. However, it is important to stress that real total human resource outlays were 10.2 (or $19 billion) higher in 1985 than in 1981. See Figure 3A.[4]

In other words, only the rate of growth, not the actual real spending level, has been cut for human resources.

2. During the 1982-1985 fiscal years, human resource outlays totaled 6.8 percent (or $57 billion) less than would have been spent if the long-run trend had continued during the Reagan years. They were 4.6 percent (or $38 billion) less than would have been spent if the Carter short-run trend had prevailed during the first four Reagan years.[5] (See Figure 3B.)

Social Security Spending

3. Through fiscal 1983, total Social Security outlays were close to the long-run trend, only to fall slightly below the long-run trend by fiscal 1985. See Figure 4A.

[Figures 4A and B]

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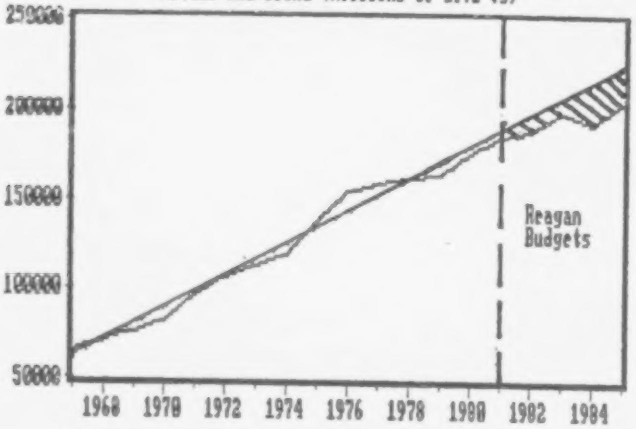
[4] Real per-capita outlays on human resources in 1985 ($854) was 6.2 percent above the per-capita human resource outlays in 1985 ($805).

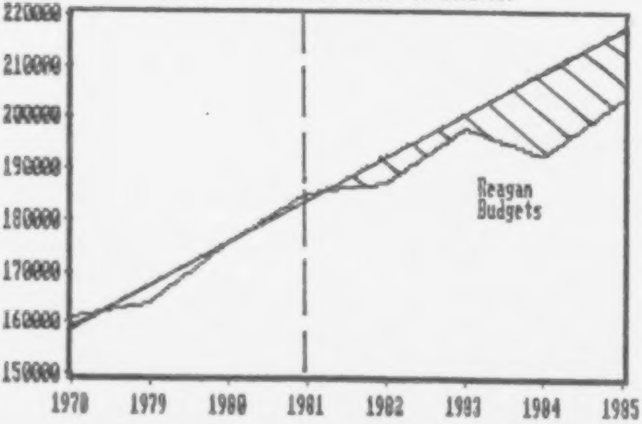
[5] Real per-capita human resource outlays in 1985 were 13.7 percent lower than they would have been if the long-run trend had continued through 1985.

Figure 3A Real Federal Outlays on Human Resources, 1967-1985
Actual and Trend (millions of 1972 $s)



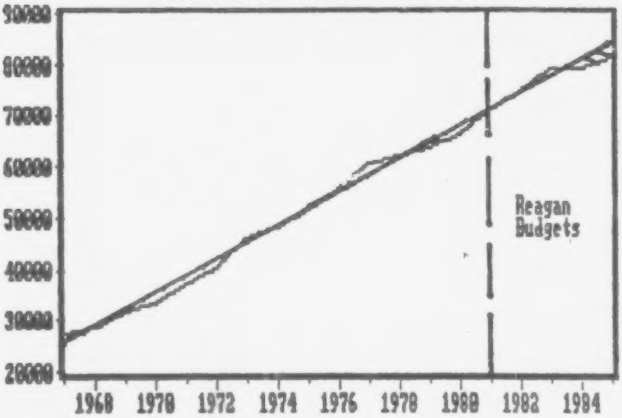
Note: Trend estimated on 1967-1981 outlays

Figure 3B Real Federal Outlays on Human Resources, 1978-1985
Actual and Trend (millions of 1972 $s)



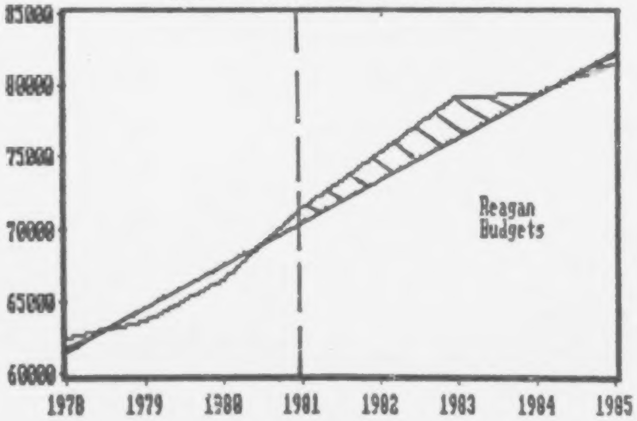
Note: Trend estimated on 1978-1981 outlays

Figure 4A Real Federal Outlays on Social Security, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 outlays

Figure 4B. Real Federal Outlays on Social Security, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimayed on 1978-1981 outlays

4. Social Security payments, in constant 1972 dollars, for fiscal 1985 were 14.3 percent (or $10 billion) above their level in fiscal 1981. Almost all of this increase, especially after 1983, was due to the growth in the number of retired citizens covered by the Social Security system, which means that Social Security payments per capita were more or less level between 1983 and 1985.[6]

5. The estimated long-run and short-run trend values for Social Security outlays were approximately the same. (See Figure 4B for the short-run trend.) In short, neither the Carter nor Reagan years appear to have affected the growth in total Social Security payments appreciably during the 1982-1985 period.

Non-Social Security Human Resource Spending

6. The federal government spent slightly more real budget dollars, 7 percent more, on non-Social Security human resources, in 1985 ($122 billion) than in 1981 ($114 billion).[7] See Figure 5A.

[Figures 5A and B]

7. Real outlays on human resource programs, excluding Social Security programs, were substantially below the long-run and short-run trends during the Reagan years. From 1982 through 1985, the federal government spent 10.5 percent (or $55 billion) less than would have been spent if the long-run trend had continued through 1985.

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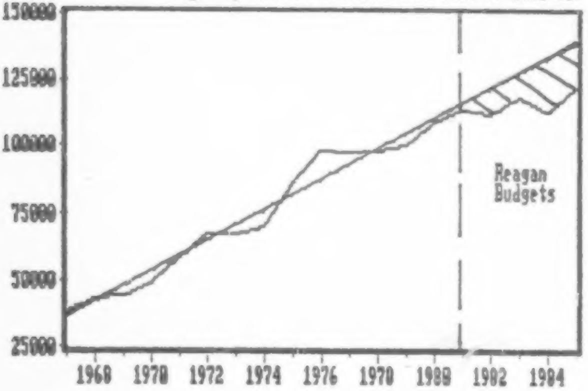
[6] Real per capita Social Security outlays were more or less the same in 1983 ($338) as in 1985 ($341) but 10 or more percent higher in those years than in 1981 ($310).

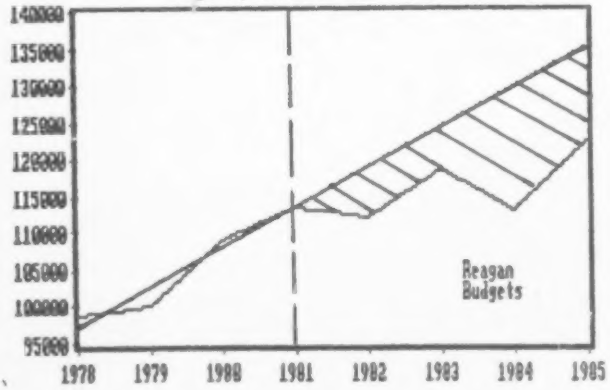
[7] The total spending increase on non-Social Security outlays resulted in a 3.8 percent ($19) increase in per capita spending between 1981 and 1985.

Figure 5A. Real Federal Outlays on Non-Social Security Programs, Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 outlays

Figure 5B Real Federal Outlays on Non-Social Security Programs, Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 outlays

8. The short-run trend in non-Social Security outlays established during the Carter years was also below the long-run trend. (See Figure 5B.) Nonetheless, the federal government spent 8.3 percent (or $42 billion) less on non-Social Security human resource payments during the Reagan years than would have been spent if the Carter trend had continued through fiscal 1985.

In other words, while it is evident that the growth in non-Social Security outlays began to slow down before 1982, the Reagan years reduced the growth rate still further. However, there were still more real dollars spent in this area in 1985 than in 1981.

Physical Resources Outlays

Figures 6A and B show what has happened in dramatic terms to federal outlays for "physical resources," mainly expenditures on energy, natural resources, commerce, housing, transportation, and community development programs.

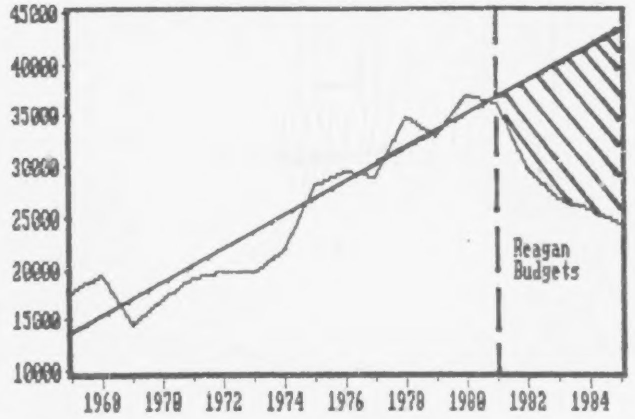
[Figures 6A and B]

Observations:

1. Substantial real cuts have occurred in physical resource spending. In 1985, real physical resource outlays were nearly 32.3 percent (or $12 billion) lower than they were in 1981.

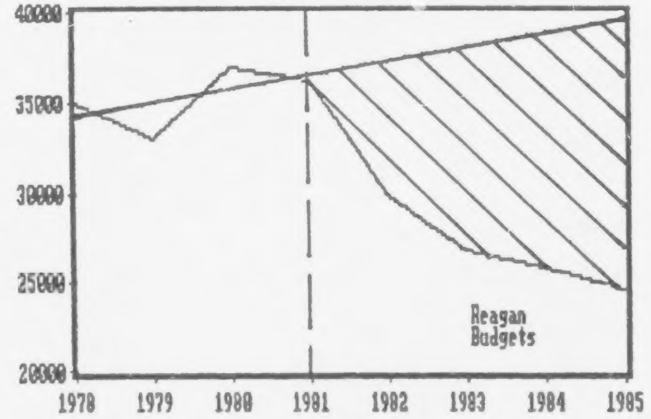
2. During the 1982-1985 period, total physical resource spending, in constant 1972 dollars, was 34.3 percent (or $56 billion) lower than would have been spent under the 1967-1981 trend and was 30.4 percent (or $47 billion) less than would have been spent under the 1978-1981 Carter trend (see Figure 6B).

Figure 6A Real Federal Outlays on Physical Resources, 1967-1985
Actual and Trend (millions of 1972 $s)



Note Trend estimated on 1967-1981 outlays

Figure 6B Real Federal Outlays on Physical Resources, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 outlays

Unfortunately, the success in cutting this area of spending makes it a less likely source for significant budget reductions. It may still be a prime target, given political resistance to cuts elsewhere in the budget, but the target is shrinking.

National Defense Outlays

Figures 7A and B confirm the widely publicized expansion in the national defense budget during the Reagan years. The sharp drop in real national defense outlays began in the early 1970s following the withdrawal from Vietnam. The reversal of the post-Vietnam downward spending trend for national defense, however, was actually begun during the Carter years.

[Figures 7A and B]

Observations:

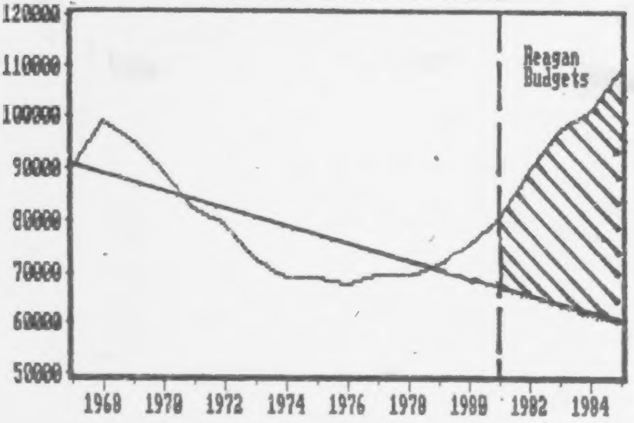
1. Real defense outlays in 1985 were 35.7 percent (or $29 billion) higher than in 1981.

2. National defense outlays for the 1982-1985 period as a whole totaled 59.3 percent (or $148 billion) higher than would have been spent under the long-term trend.

However, given the reason for the decline in real defense spending in the 1970s, it is highly unlikely that the downward trend estimated for the 1967-1981 period would have continued, regardless of who held the presidency in 1982-1985. The rise in President Carter's spending for defense reflects this. (See Figure 7B.)

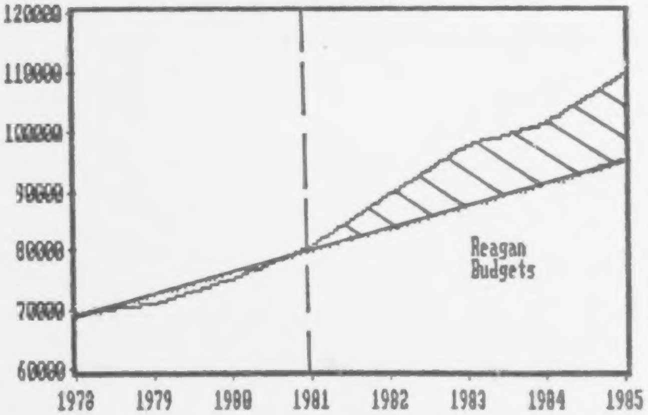
3. The rise in defense spending as a percentage of GNP has been strikingly modest, given the public controversy over the issue.

Figure 7A Real Federal Outlays on Defense, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 outlays

Figure 7B Real Federal Outlays on Defense, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 outlays

National defense spending rose from 5.3 percent of GNP in 1981 to 6.3 percent in 1985.[8]

4. If the short-run trend established during the Carter years had continued through 1985, national defense spending would still have been 42.5 percent (or $106 billion) more during the 1982-1985 period than would have been spent under the long-run trend. This means that real national defense spending rose during the Reagan years by 11.8 percent (or $42 billion) more than would have been spent had Carter's short-run trend continued.

There is no question the President is committed to increased defense spending. It should also be obvious that, in spite of annual Congressional protests, Congress has acquiesced to the major buildup in military spending. In fact, the increased spending for defense during the 1982-1985 period appears to be only slightly larger than projections from trends established during the Carter years.

Net Interest outlays

Net interest payments of the federal government for the 1967-1985 period, along with the trend lines, are graphed in Figures 8A and B. The interest payments are a function of both the year-to-year additions to the real national debt, which has grown substantially during the Reagan years, and interest rates, which have moderated during the Reagan years.

[Figures 8A and B]

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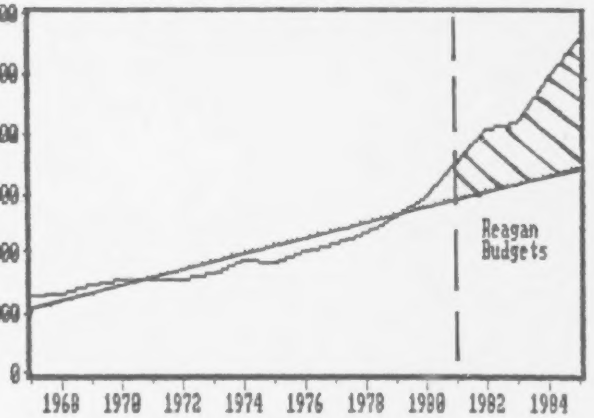
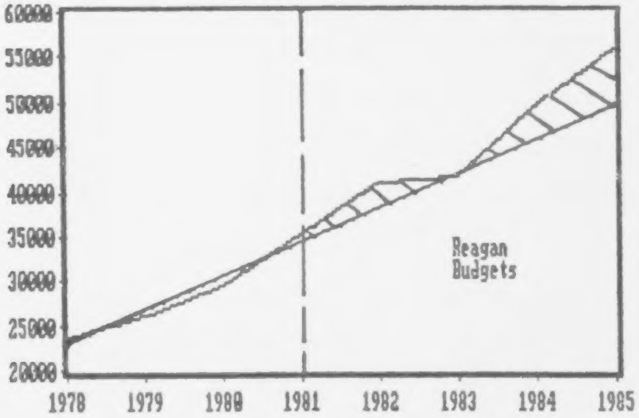
[8] During the 1967-1981 period, defense spending as a percent of GNP reached a high of 9.3 percent in 1968 and a low of 4.8 percent in 1979.

Figure 8A Real Federal Interest Payments, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 payments

Figure 8B Real Federal Interest Payments, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 payments

Observations:

1. Real interest payments were 59.2 percent (or $21 billion) higher in 1985 than in 1981, due in large measure to the substantial rise in budget deficits from $38 billion in 1981 to over $90 billion in 1984 and 1985.[9]

2. Real interest payments during the 1982-1985 period were 45.6 percent (or $59 billion) more than would have been projected under the 1967-1981 trend.

3. Real interest payments rose during the Carter years. As a consequence, during the 1982-1985 period, real interest payments were only 7.4 percent (or $13 billion) higher than they would have been if the short-run trend had continued through 1985. (See Figure 8B.)

Other Federal Outlays

"Other" federal outlays -- federal functions not covered above (i.e., international affairs, science, agriculture, justice, and general government) -- and the trend line for this "catch all" category are graphed in Figures 9A and B.

[Figures 9A and B]

Observations:

1. Real federal outlays on all other functions grew by slightly more than 22.5 percent (or $5 billion) between 1981 and 1985.

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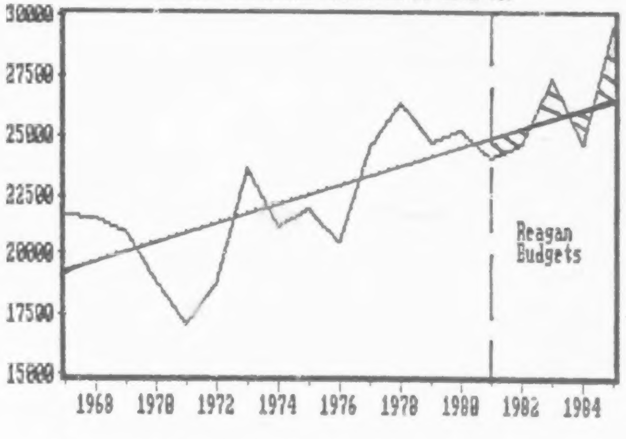
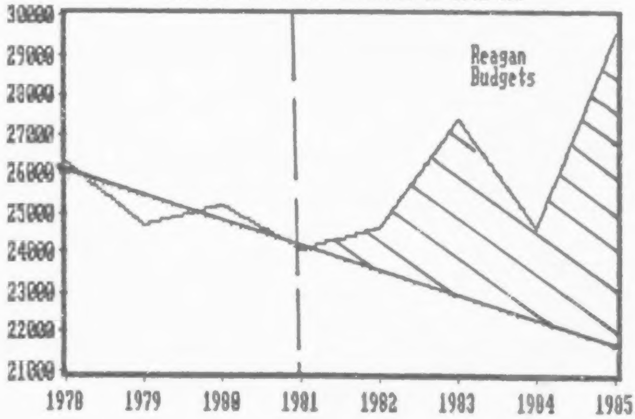
[9] The real federal deficit was 143 percent (or $54 billion) higher in 1985 than in 1981. During the 1982-1985 period, the federal government added 72.2 percent (or $118 billion) more than would have been added under the long-run trend (which was upward) and 134.4 percent (or $162 billion) more than would have been added under the short-run trend (which was downward).

Figure 9A. Other Real Federal Outlays, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 outlays

Figure 9B Other Real Federal Outlays, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 outlays

2. Other outlays from 1982 to 1985 expanded irregularly along the long-run trend, resulting in a net increase in outlays during the 1982-1985 period of 2.8 percent (or $3 billion) more than would have been spent under the long-run trend.

3. During the Reagan years, however, 17.5 percent (or $16 billion) more was spent on other programs than would have been spent had the trend established under Carter continued through 1985 (see Figure 9B). (Much of the increase in these other real dollar outlays was for agriculture programs.)

In short, these miscellaneous outlays have expanded significantly in real terms during the Reagan years.

REAL FEDERAL RECEIPTS

Total Receipts

Total receipts of the federal government for the 1967-1985 period are shown in Figures 10A and B. Total receipts as a percent of GNP is shown in Figures 11A and B.

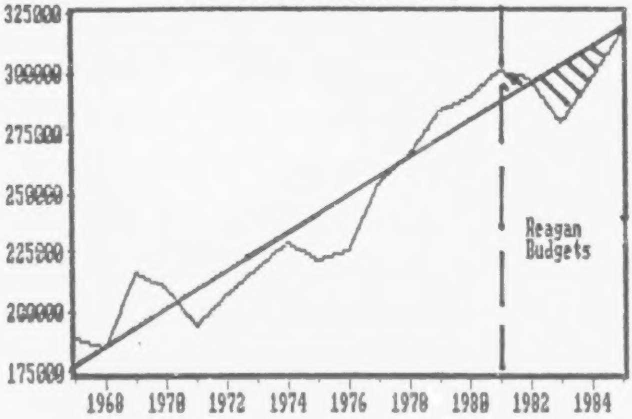
[Figures 10A and B]

Observations:

1. Total federal receipts from all sources were higher in 1985 than in 1981. Indeed, the federal government received in real dollars 5.3 percent (or $16 billion) more in 1985 than in 1981.

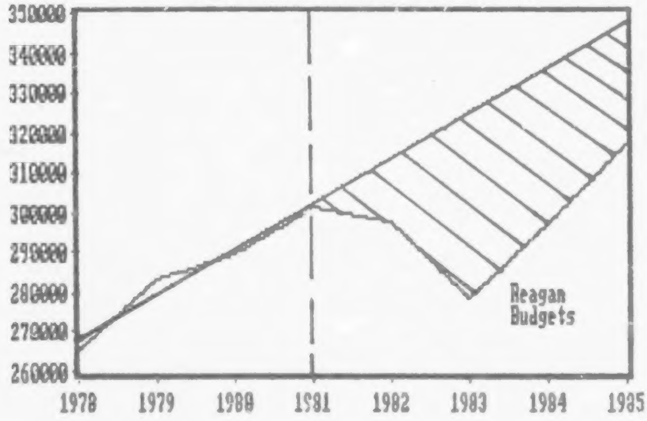
2. Due to the 1981 personal and corporate tax-cut package and the two recessions of the early 1980s, total receipts fell between 1981 and

Figure 10A Real Total Federal Receipts, 1967-1985
Actual and Trend (millions of $s)



Note: Trend estimated on 1967-1981 receipts

Figure 10B Real Total Federal Receipts, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 receipts

1983. However, they had returned to the long-run trend by 1985.[10]

3. In real terms, the federal government, on balance, actually collected in 1985 only .5 percent (or $1.5 billion) less in total revenues than would have been collected had the long-run growth trend continued through 1985.

In other words, using the long-run trend as the basis for comparison, in spite of the all the talk of tax cuts during the Reagan years, total 1985 receipts were cut inconsequentially during the Reagan years. Real tax receipts have only returned to the upward long-run trend.

4. If the Carter trend had prevailed through 1985, the federal government would have collected throughout the 1982-1985 period 9.8 percent (or $130 billion) more than was actually collected.[11] (See Figure 10B.)

4. Total receipts as a percent of GNP were lower in 1985 (18.4 percent) than they were in 1981 (19.9 percent) or would have been under the long-run trend (19.2 percent) or short-run trend (22.0 percent). See Figures 11A and B.

Whereas the long-run trend for total receipts as a percent of GNP was more or less level and the short-run trend was rising (at about a half a percent per year), the trend of receipts as a percent of GNP estimated for the Reagan years was downward (falling at about a half percent per year). This downward trend is in jeopardy of being reversed once again, given congressional discussions of "revenue enhancement" measures.

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[10] Total receipts per capital were slightly higher, 1.5 percent, in real terms in 1985, $1,329, than they were in 1981, $1,310. They were less than they would have been, 2.1 percent in 1985 under the long-run trend.

[11] The upward trend in total receipts was spurred in part by escalating inflation rates, which were drastically moderated during the first Reagan term. The reversal in the inflation trend contributed, of course, to the twin recessions of the early 1980s and reductions in tax collections.

[Figures 11A and B]

Personal Income Tax Receipts

Real income tax receipts in total are show in Figures 12A and B.

[Figures 12A and B]

Observations:

1. Real income tax receipts were nearly the same (1.1 percent, $2 billion less) in 1985 as in 1981.

2. While income tax receipts (in total and per capita) were significantly below the trend from 1982 to 1984, the sustained economic recovery has brought these figures closer to the long-run trend value in 1985.[12]

3. Income tax receipts for 1982-1985 were 3.8 percent (or $22 billion) the long-run total for the period (see Figure 12A) and 16.6 percent (or $111 billion) below the short-run total for the period (see Figure 12B).

In other words, personal income taxes were reduced (at least temporarily[13]) during the Reagan years substantially when compared to

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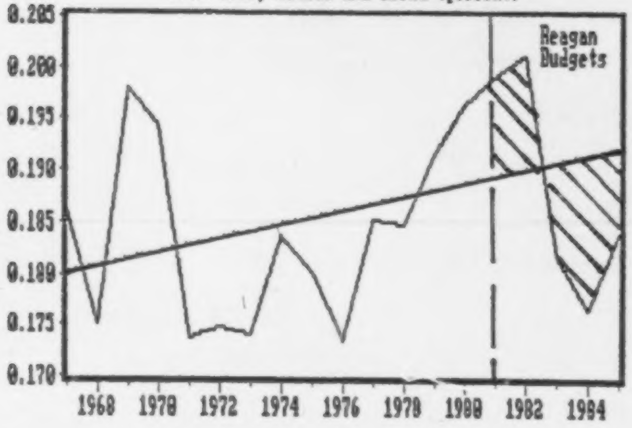
[12] Per-capita income taxes fell by 10.2 percent between 1981 ($1310) and 1983 ($1189) but in 1985 were 1.5 percent above the 1981 level and 1.5 percent below the long-run trend estimate for 1985.

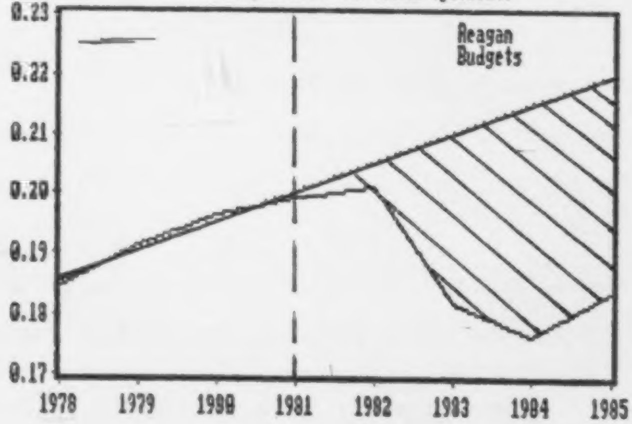
[13] Some of the reduction in tax collections was, of course, due to the recession.

Figure 11A Total Federal Receipts as a Percent of GNP, 1967-1985, Actual and Trend (percent)



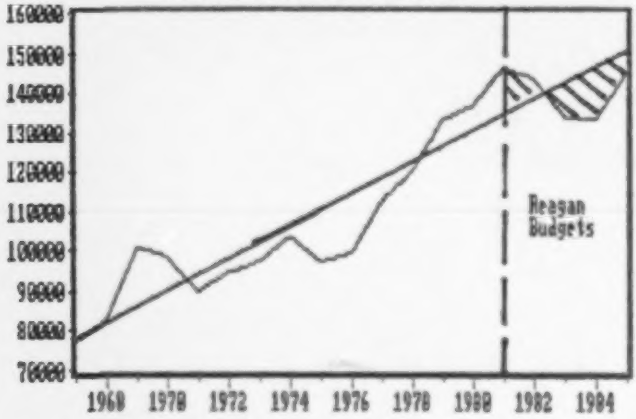
Note: Trend estimated on 1967-1981 percentages

Figure 11B Total Federal Receipts as a Percent of GNP, 1978-1985, Actual and Trend (percent)



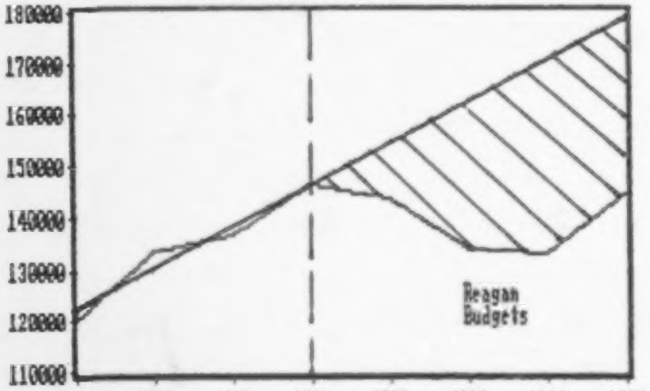
Note: Trend estimated on 1978-1981 percentages

Figure 12A Real Personal Income Tax Receipts, 1967-1985
Actual and Real (millions of $s)



Note: Trend estimated on 1967-1981 receipts

Figure 12B Real Personal Income Tax Receipts, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 receipts

the long-run trend but only marginally when compared with the short-run trend.

Corporation Income Tax Receipts

Corporate income taxes are plotted along with the trend in Figures 13A and B.

[Figures 13A and B]

Observations:

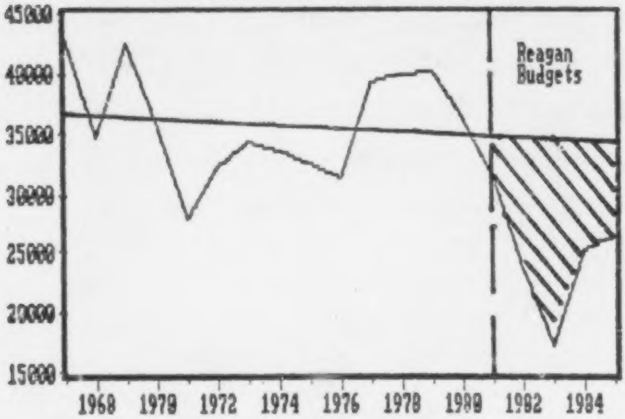
1. Federal corporate income taxes were trending downward in both the 1967-1981 and 1978-1981 periods. However, corporate income tax receipts dropped significantly during the Reagan years by 15.2 percent (or from $31 billion in 1981 to $27 billion in 1985).

2. During the 1982-1985 period, the federal government collected 32.4 percent (or $44 billion) less in corporate income taxes than would have been collected under the long-run trend.

3. Further decreases in corporate taxes appear to have been been in the making, given the trend established during the Carter years. Corporate tax receipts during the Reagan years were only 7.1 percent (or $7 billion) lower than what would have been projected under the short-run Carter trend (see Figure 13B).

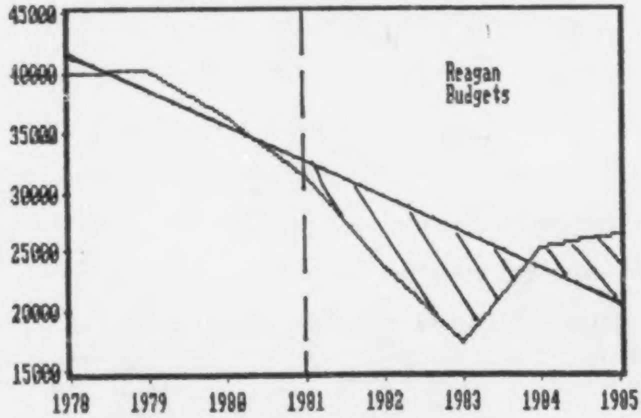
4. To be sure, the serious recessions experienced during 1981 to 1983 have played a major role in reduced receipts from corporations. Since companies can carry-forward losses into future tax years, corporate taxes for 1984 and 1985 were also affected by the recession. Nonetheless, the magnitude of the drop in corporate income tax receipts is significantly greater than any other period from 1967 to 1981.

Figure 13A Real Corporation Income Tax Receipts, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 receipts

Figure 13B Real Corporate Income Tax Receipts, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 receipts

Since the president has often shared his views that "corporations don't pay taxes, people do," it is not surprising that corporate income taxes would decline in the Reagan years. The magnitude of this decline appears to reflect the fact that Congress too has come to believe that corporate taxes have been too high in the past and that capital investment should not be retarded by corporate taxes.

Social Security Tax Receipts

Real Social Security taxes are shown in Figures 14A and B.

[Figures 14A and B]

Observations:

1. Social Security tax collections in real terms rose in virtually a straight line between 1967 and 1985. However, they were 22.7 percent (or $21 billion) higher in 1985 than in 1981.

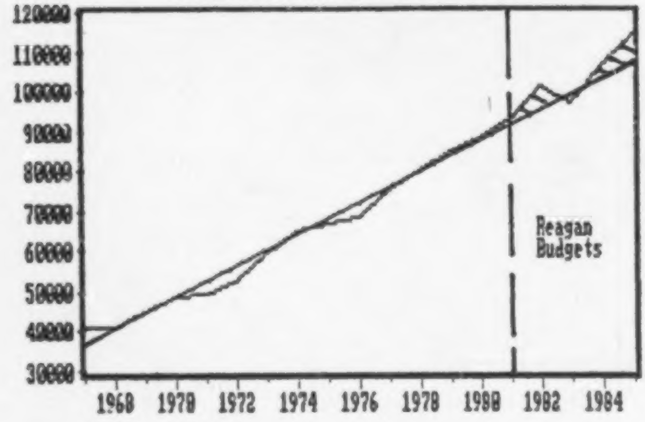
2. Slightly more Social Security taxes were collected during the Reagan years than would have been collected under either the long-run or short-run trend. (See Figures 14A and B.) The Reagan Social Security tax collections during 1982-1985 were 3.7 percent (or $15 billion) more than under the long-run trend and only 1.2 percent (or $5 billion) more than under the short-run trend. This, of course, reflects the Social Security rate and base increases passed during the Reagan years.

Excise Tax Receipts

Real excise tax collections are presented in Figures 15A and B.

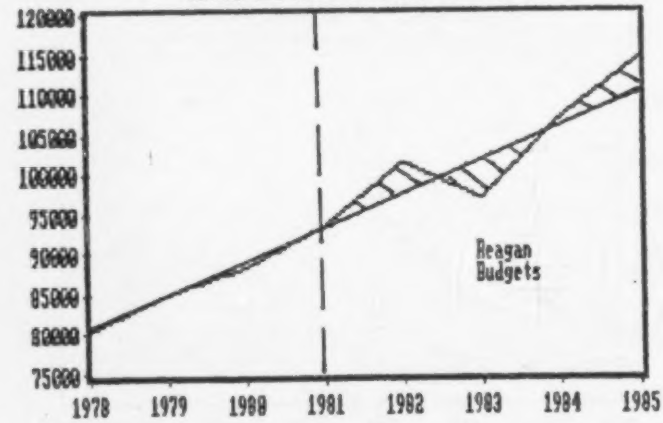
[Figures 15A and B]

Figure 14A Real Social Security Taxes, 1967-1985
Actual and Trend (millions of 1972 $s)



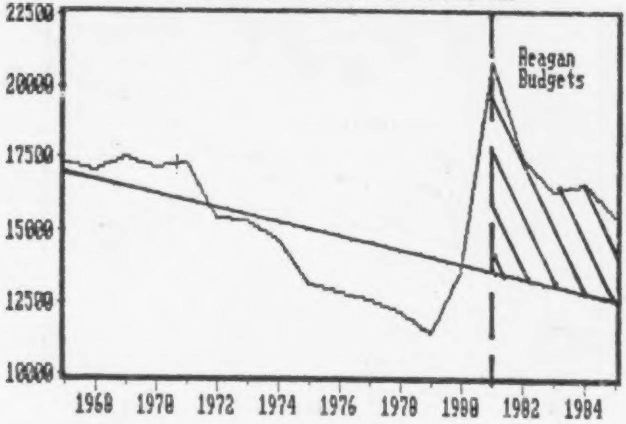
Note: Trend estimated on 1967-1981 taxes

Figure 14B Real Social Security Taxes, 1978-1985
Actual and Trend (millions of 1972 $s)



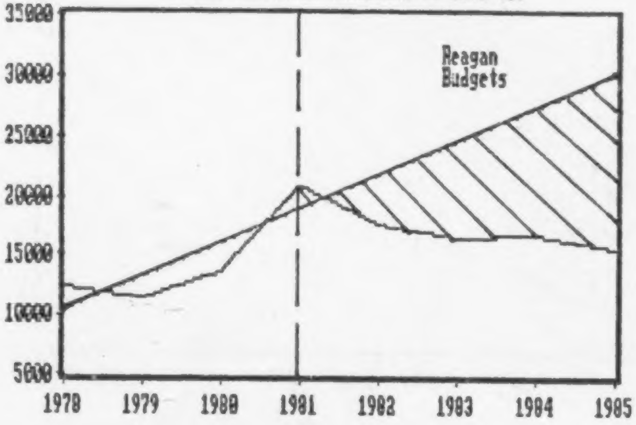
Note: Trend estimated on 1978-1981 receipts

Figure 15A Real Federal Excise Taxes, 1967-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1967-1981 taxes

Figure 15B Real Federal Excise Taxes, 1978-1985
Actual and Trend (millions of 1972 $s)



Note: Trend estimated on 1978-1981 receipts

Observations:

1. Between 1967 and 1981 real excise tax collections were generally moving downward (although they began to soar in 1980).

2. Between 1981 and 1985 annual excise tax receipts fell substantially, by 25.5 percent (or $5 billion). However, real excise tax collections were still 23.8 percent (or $3 billion) above the long-run trend in 1985.

3. Real excise tax receipts during the 1982-1985 period were also 48.2 percent (or $14 billion) below what would have been collected under the long-run trend.

4. If the trend in excise taxes established during the Carter years had continued through 1985, however, excise tax collections for the 1982-1985 period would have totaled 36 percent (or $37 billion) more than they actually were. (See Figure 15B.)

In summary, excise tax collections were lower in 1985 than 1981 (or, for that matter, 1971) but were much higher than in 1979. The downward drift of real excise tax receipts during the late 1970s was probably due to a significant extent to the then-escalating rate of inflation, which reduced the real value of excise taxes that are frequently specified in nominal dollar terms (so many cents or dollars per item sold).

SUMMARY

Table 1 summarizes the findings of this budgetary study. It contains the real dollar and percentage comparisons, noted in the body of this report, between actual federal outlays in 1981 and 1985 and between actual expenditures in the 1982-1985 period versus long-run and short-run projected expenditures and receipts for the period.

[Table 1]

As is evident in Table 1, important sizable shifts have occurred in the federal budget during the Reagan years. In general, during the 1981-1985 period, three conclusions are worthy of special attention.

* First, total federal outlays, in real dollar terms and as a percent of GNP, continued upward during the Reagan years. Meanwhile, total real receipts have also risen, but not as rapidly as outlays. However, the growth in total receipts as a percent of GNP may have been reversed.

The President's statement that continued growth in spending is to blame for the huge deficits is largely correct. However, it is also accurate to say that reduced growth (not the absolute level) of real federal receipts is also playing a role. It seems the administration and Congress have done a better job of getting IRS's hands out of our wallets than in getting government off our backs.

* Second, spending priorities have undergone a major shift during the past four years. Defense spending has grown drammatically but little of this growth has occurred at the expense of progam areas, except perhaps physical resources. Only physical resources has taken a major cut; but outlays in this category are practically "petty cash" compared to defense, Social Security, interest payments, etc.

The charge that welfare programs as a group have been dealt a crippling blow appears to be largely without merit.[14] Only the growth rate of these programs has been cut -- real spending for non-Social Security human resources was higher in 1985 than in 1981. This may well reflect congressional priorities rather than presidential wishes, however. Complaints about spending cuts appear to be largely complaints about the realignment of presidential and congressional priorities among non-Social Security programs.

Social Security is a sure bet to survive any reordering of priorities. It is one sacred cow that no one dares to touch. Real expenditures for Social Security have followed a long term growth trend that would be the envy of any publicly held corporation.

* Lastly, the dramatic drop in corporate income tax receipts during the 1982-1985 period may make this revenue area more vulnerable to "revenue enhancements." At any rate, the pressure to reduce the deficit to meet the Gramm-Rudman-Hollings schedule will surely test congressional committment to corporate investment incentives in the tax code.

All in all, if the past long-run fiscal record is any guide to the future, real federal outlays and receipts will continue their upward trek. Expenditures will be slowed somewhat, while receipts will be "enhanced," returned to their historical rate of growth. There is little reason to believe that the Gramm-Rudman budget amendment will do anything other than somewhat slow the speed with which the federal government is able to return to its established growth path.

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[14] This study could not assess the changes in federal real outlays that go to poor people. The required data are not available.

Table 15 Federal Outlays and Receipts, Actual and Linear Projections, 1967-1985
Fiscal Years

(billions of 1972 dollars except where percent indicated)

						Projections					Differences between Projections & Actual Figu						
	Actual Budget Figures					Long-Run[a]		Short-Run[b]			Long-Run				Short-Run		
Budget Categories	Level 1981	Level 1982	Sum of 1982 through 1985	Level 1985 Minus 1981 (2)-(1)	Percent Difference (4)÷(1)	Level 1985	Sum of 1982 through 1985	Level 1985	Sum of 1982 through 1985	Actual Level 1985 Minus Projected Level 1985 (2)-(6)	Percent Difference (10)÷(4)	Actual Sum 1982-85 Minus Projected Sum 1982-85 (3)-(7)	Percent Difference (12)÷(3)	Actual Level 1985 Minus Projected Level 1985 (2)-(8)	Percent Difference (14)÷(2)	Actual Sum 1982-85 Minus Projected Sum 1982-85 (3)-(9)	Percent Difference (16)÷(3)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
Total Outlays	346,733	409,061	1,526,666	62,328	18.0	373,785	1,432,542	404,373	1,528,443	35,276	9.4	94,124	6.6	4,688	1.2	-1,777	.1
Percent of GNP	22.9	23.7				22.8		23.6									
Human Resources	185,083	203,978	781,961	18,895	10.2	223,379	839,164	217,506	819,714	-19,401	-8.7	-57,203	-6.8	-13,528	-6.2	-37,753	-4.6
Social Security	71,362	81,535	315,527	10,173	14.3	84,366	317,824	82,270	311,323	-2,831	-3.4	-2,297	-.7			4,204	1.4
Non-Social Security	113,721	122,443	466,434	8,722	7.7	138,913	521,341	135,228	508,392	-16,470	-11.9	-54,907	-10.5	-743	-.9	-41,958	-8.3
Physical Resources	35,240	24,548	106,919	-11,692	-32.3	43,134	162,705	39,580	153,660	-18,586	-43.1	-55,786	-34.3	-15,032	-38.0	-46,741	-30.4
National Defense	80,528	109,254	397,533	28,726	35.7	59,823	249,542	94,470	355,629	49.431	82.5	147,991	59.3	14,784	15.6	41,904	11.8
Net Interest	35,140	55,950	188;167	20,810	59.2	34,283	129,234	49,502	175,155	21,667	63.2	58,933	45.6	6,448	13.0	13,012	7.4
Other Outlays	24,077	29,492	106,190	5,415	22.5	26,429	103,334	21,655	90,362	3,063	11.6	2,856	2.8	7,837	36.2	15,828	17.5
Total Receipts	301,264	317,307	1,191,388	16,043	5.3	318,820	1,228,312	347,331	1,321,387	-1,513	-.5	-36,924	-3.0	-30,024	-8.6	-129,999	-9.8
Personal Income	146,174	144,606	555,475	-1,568	-1.1	150,354	577,302	178,726	666,273	-5,748	-3.8	-21,827	-3.8	-34,120	-19.1	-110,798	-16.6
Corporate Income	31,256	26,511	92,810	-4,745	-15.2	34,114	137,268	20,496	99,855	-7,603	-22.3	-44,458	-32.4	6,015	29.3	-7,045	-7.1
Social Security	93,415	114,621	419,961	21,206	22.7	107,062	404,800	110,151	415,150	7,559	7.1	15,161	3.7	4,470	4.1	4,803	1.2
Excise Taxes	20,879	15,558	66,126	-5,321	-25.5	12,569	51,736	30,034	103,246	2,989	23.8	14,390	27.8	-14,476	-48.2	-37,120	-36.0
Budget Deficits	37,730	91,770	281,908	54,040	143.2	43,726	163,711	28,957	120,272	48,044	109.9	118,197	72.2	62,813	216.9	161,636	134.4
Percent of GNP																	

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Note: [a] Long-run projections are based on 1967-1985 budget figures.

[b] Short-run projections are based on 1978-1981 budget figures.

Senator Roth. Let me go back to the recent change in projections and make sure I understand each one of you.

Do all four of you agree that it looks like we are in a period of sustained growth and we have the right policies?

I think, Mr. Rahn, you made a statement that you couldn't recall a recent period in which there appeared to be a better opportunity for continuous growth if we are just intelligent enough to set the proper policies.

Do all of you agree or are there any dissenters with respect to this projection?

Mr. Harriss.

Mr. Harriss. There have always been setbacks. Although I am optimistic generally, I would not be surprised if, between now and 1991, there were not some periods that were less good than we would like. But no major recession.

Senator Roth. No major recession?

Mr. Harriss. No.

Senator Roth. So what could bring about those bumps in the road? Are you able to anticipate them at this time?

Mr. Harriss. No; I would not venture to be precise. There might be something in the international sphere; it might be the kind of uncertainty we are going about in the tax bill. I cannot see anything now except possible financial troubles in the international sector, but there might be others.

Senator Roth. Mr. Roberts.

Mr. Roberts. Mr. Chairman, I would say that there are some risks that monetary policy could be mismanaged. For the past 5 years, we have had to live with totally uninformed hysteria about the deficit, and it has had a big effect on the Federal Reserve, which still thinks the main problem is inflation, and that inflation is around the corner and is about to jump back and get us any minute if the economy starts to grow.

That is the entrenched view of the Federal Reserve. it is certainly the view that has informed the Chairman these past 5 years. it is a view that, if far off the mark, could do tremendous destructive damage to the outlook. If what we are seeing is rapid and unexpected disinflation and some prospect of that turning into actual deflation, while the Federal Reserve Chairman is out warning about inflation or worried that if he lets the economy grow very much we will have inflation, you could find a miscalculation.

And since none of us can control that decision and as far as I can tell, there is very little accountability, I would have to say that monetary policy remains a point of concern and certainly could be the source of an enormously worst budget outlook in the future. That potential, I think, is there.

Now, there have been recent appointments to the Federal Reserve, including my former deputy from the Treasury, and I think you will find it will bring a more balanced view toward monetary policy. if they succeed, we should be able to reap the fruits of a good economic performance.

Senator Symms. On that point—I don't want to interrupt Senator Roth's questioning—I would like to say that in my part of the country you couldn't convince anybody that the economy is in anything but a state of depression, and I say that because we earn our living farming, mining, and harvesting timber.

There are a few bright spots in microchips and so forth, but primarily people are very down, depressed. Real estate values are down and there is a state of economic despondency out there among the public.

When do you think that is going to turn around?

Mr. ROBERTS. Well, I think, Senator Symms, that those economic conditions are a direct result of the unexpected sharp fall in the inflation rate; that is, it is the consequence of unexpected policy. I think the Federal Reserve clearly miscalculated.

Senator SYMMS. That was back in 1982?

Mr. ROBERTS. It goes back to 1981, when they were influenced by a lot of politics and by a lot of claims that the Reagan tax cuts would send inflation to the other side of the Moon. They were also influenced by the experience of the 1970's when people were trying to get the economy to grow by pumping in money.

As long as the Fed has the idea that economic growth causes inflation, I don't know how well the economy will do.

Senator SYMMS. Let me just pursue that a little further, and if any of the rest of you want to comment on that.

This goes back to the question—you were all in the room when I asked Mr. Miller about Peter Domenici's $9 billion that he would like to add to this budget. In politics, the perception often becomes what is true, and the perception by Chairman Volcker, as I interpret it, is that if he thinks the Congress is going to keep on meeting the target, then he tries to respond with a little bit more of an accommodative nature at the Fed.

Now, I agree with you. We have farmers all over Idaho that are crushed by debts that they still carried when they were paying 17 and 18 percent interest rates, and they borrowed money against a mortgage to pay off the interest, and now they have a massive debt burden out there that they are still struggling with. But every day when rates go down, it helps us.

The dilemma that I am asking about, looking at it from a resource producer's part of the country where we are very interest rate sensitive, is our need for the rates to come down another 3 or 4 market points to become competitive in agriculture and mining operations.

If there is a perception that the Congress is going to meet the targets of Gramm-Rudman and therefore the Fed accommodates and interest rates keep on drifting downward, wouldn't that almost be better than creating a roadblock and a simulated scare here in Washington if you can't quite get your way, or wouldn't it?

I happen to agree with your economic thesis and what all of you have said. I don't think we need a tax increase.

I wish he would just cut $9 billion out of another part of the budget—it wouldn't make a whole lot of difference where in terms of the economy—and not worry about such a small amount.

On the other side of the coin, maybe you could say it is a small amount in a revenue context.

So comment on that.

Mr. ROBERTS. I don't personally think $9 billion on the deficit more or less makes any difference. I don't think, given the size of the economy, that it would make any difference whether the deficit is $9 billion larger or $9 billion smaller.

I think you probably make a mistake when you agree to $9 billion higher taxes, because the next thing you know they will want $15 billion and $20 billion and then $30 billion. Once you start compromising, if you don't control the deals, you end up with a change in policy.

Now, from the standpoint of the Federal Reserve, it is my opinion that the deficit has been an excuse for the Federal Reserve to be tight and that they could just as well find another one.

The dollar, for example. If it looks like the deficit is coming down and they want an excuse for a tight policy, the Fed will start talking about the dollar. They will claim that a cut in interest rates will cause the dollar to go down too much and bring back inflation.

So I am skeptical of the notion that we would have had lower interest rates if the Congress did a better job of reducing the deficit. I don't think that was the basis of the Fed's reasoning.

Senator SYMMS. But you had the chairman come over and tell the Congress he would stand in front of the budget and if you will do this, I will do that. It was veiled, but that was the perception, and that almost became the truth out in the market.

Mr. ROBERTS. Well, people are busy and they read the newspaper, and often they have to rely on information that is not very good.

Senator SYMMS. Mr. Rahn, would you comment on that question?

Mr. RAHN. Well, I agree with Craig Roberts that the $9 billion figure is barely measured in a $4 trillion economy. But once you concede that we are going to be better off rather than worse off with a tax increase, I think you are on a very slippery slope, and we have seen it happen so many times in the past.

We said, well, we will get a little bit of a tax increase and we will do the spending, and the spending is never done, and I think that we have an opportunity if you all see your colleagues and the rest of us to get out there and try to make it known in your States and other places that we indeed will be worse off rather than better off, that it is going to slow economic growth the same way as TEFRA with the 1982 recession, and a lot of people suffered because it was such a modest little thing to do. It didn't hurt anybody in this room, but it hurt a lot of people out in the countryside.

And I just think we ought to go ahead and resist and stand up and speak the truth that a $9 billion or $70 billion tax increase isn't going to bring down the deficit, and it is going to make us worse off, and there is going to be more poor rather than fewer poor if you do that.

Senator ROTH. Mr. McKenzie.

Mr. MCKENZIE. I'm not very good at perceptions. That's your business, I guess, more than mine certainly, but it would appear to be that if you're looking for some sort of psychological impact to minimize the tax increase, you could go for $1 billion.

Why $9 billion? That's the point.

Senator SYMMS. The point I'm trying to get at is I would like to see Congress move along as though it's going to pass Gramm-Rudman.

Mr. MCKENZIE. Now, my own estimate is, if oil prices keep tumbling and interest rates keep coming down, you may never need the $9 billion in revenue, but if you stop the process right now, everybody in the New York bond market and the Chicago Board of Trade, they're all going to be screaming Congress is going backward on Gramm-Rudman, and pretty soon the bonds are going down and there's going to be a perception of higher interest rates coming back and everything gets slowed down psychologically based on a myth.

I agree it may be a myth, of course, but I can't believe that $9 billion is worth arguing about.

Senator SYMMS. Well, let's agree that it is a psychological impact. What's bothering me is that the chairman tells me my vote will make a difference whether we can move the budget or not.

Mr. McKENZIE. Well, let's accept the fact there's a psychological impact there, but suppose if people believe another myth or another likely effect, that is, the $9 billion will give rise to more Federal expenditures than otherwise and then we continue on an upward trek of the Government taking a greater percentage of the GNP.

Senator SYMMS. I would be against that because I think we have too much Government, period.

Mr. McKENZIE. Well, the point is the psychological impact that you are suggesting can be offset by the real impact of Federal expenditures, which also has a real impact but can also have a psychological impact, and so I think that maybe the core of the resistance on this panel to a tax increase is founded in the belief that there is an offsetting impact.

Expenditures may be up higher than they otherwise would and I think if you just look at the charts and so forth in my tables we have a real fear of going back up to the Carter trend in terms of government as a percentage of the GNP.

And we're back to the long-term trend, which is still up, but between 1984 and 1985 we digressed away from it.

Senator SYMMS. How long do you think it will take the economy to recover from the so-called tax revenue bills that have been floating around here?

How long will it take to recover if we don't do something and pass one of these things?

Mr. McKENZIE. It's having a difficult time now just contemplating it.

Senator SYMMS. Do you see an effective date as hurting our recovery now?

Mr. McKENZIE. What?

Senator SYMMS. Do you see the effective date as hurting our economy right now?

Mr. McKENZIE. Yes.

Senator SYMMS. Let me ask a question there. I think, Mr. Rahn, you raised that point. There's been some talk that the Finance Committee should refuse to proceed with markup until such time as there is agreement on the effective date.

Would you care to comment on that possibility?

Mr. RAHN. I think that would be most desirable because, I mean, every day I see the uncertainty of building out there, the situation gets worse, and as I said, we ought to have a 5-percent rate of real economic growth.

But I also want to comment on Senator Symms' point that the budget won't go through if the chairman doesn't get your vote.

Well, the President has very flatly stated time and time again, and I know the people around the President all believe that he won't approve a budget that has a tax increase, and I would argue that if you go ahead on the Budget Committee and approve the tax increase there will be more uncertainty from the financial markets and we'll be worse off because I don't believe the president will sign the thing.

They believe it's just a charade and I believe you have to force your colleagues to come up with a budget without a tax increase in it.

Senator **Symms**. Well, I appreciate that answer but my strategy would be to vote for it on the Budget Committee and go on the floor and try to take the tax increase out. But maybe that's a poor strategy.

Senator **Roth**. Mr. Roberts.

Mr. **Roberts**. Senator Roth, I'd like to give you an example of what the tax uncertainty is doing. It's not just a question of the effective date. I think it's also a question of provisions.

Right now, or as of yesterday afternoon, the yield on investment grade tax exempt bonds was identical to the yield on taxable Federal Government bonds.

That has never before occurred in our history. As I was saying, yesterday at the close of the bond market, the yield on tax exempt bonds was identical to the yield on the Treasury taxable bonds, and this has never occurred in our history.

I think what you have here is uncertainty overhanging the municipal bond market such that there is no longer any difference in yield between the municipals and Treasury's. And I think this is an enormous signal of incredible uncertainty at a level that has to be affecting the entire economy in the way that Richard Rahn said.

So my own view is that the economy is faced with uncertainty over a tax reform bill that is not any good anyhow and should never have had any of the President's political capital invested in it, if he was well-advised. The uncertainty of this bill is going to do more damage than the budget. In my view, the Gramm-Rudman Act has little to do with falling interest rates. The rally began long before Gramm-Rudman and continued despite unfavorable court rulings and despite the statements of the Budget Committee chairman.

I think that the bond market has simply discovered that the deficit theory of interest rates is hokum. The bond market is adjusted to that fact, because it has discovered that the deficit does not determine interest rates. We might lose some of the decline in interest rates if there is a budget stalemate, but I don't believe there would be a substantial change. I think, however, if you don't do something about the tax reform uncertainty, particularly if there is a mistaken monetary policy, you could really have a serious problem.

It's always better to clear up uncertainties than to generate them.

Senator SYMMS. Mr. Chairman, if I might, I just want to thank the witnesses here this morning and particularly I want to thank you for your leadership in getting this hearing together.

My only regret is that we don't have all of our colleagues here to hear these witnesses, because I think there is a message to be heard by more and more people in the country. I certainly compliment you for your efforts to get this group together and get this on the record and I will do my part to help distribute this information to our other colleagues. And I do appreciate it.

I think it's very helpful information and I'm certainly glad to hear it and hope that we can do some things in the Finance Committee, which we are both on, to clarify some of this uncertainty.

I think my questions about tax reform and effective date and uncertainty have been answered quite well and, although maybe I didn't get the answer I would like to have heard about the Domenici bill, it may be a good thing I heard about it before I went up to his office.

Senator ROTH. I would just like to underscore that. I sat in the White House in January and I think you were there, too, when some of the same people were proposing a tax increase.

I can't remember what the figure was. I think they were talking about $15 billion or more. I think you can guarantee that if we agreed to a tax increase now that before you get through with the House and the whole process, it's going to be substantially higher. And for that reason, I agree with these gentlemen.

I think it is the wrong way for us to go at this stage. I do have a few other questions.

Mr. Harriss, you had a comment you wanted to make.

Mr. HARRISS. I was just going to say there may not be many things Congress can do, but one thing you can do at the moment is reduce the uncertainty about dates.

It seems to me that it is not a costly thing to do. Two gentlemen, leaders from each House of Congress, should be able to resolve the doubt in 5 minutes and get the uncertainty removed.

The effective date issue should be soluble simply and promptly.

Senator ROTH. I agree with that and I think we should; otherwise, it could be very much an issue in the conference for purposes of compromise, so I would hope it would stand firm on that.

One of the things that bothers me, as I said earlier, is that the message is not getting out to the public at large that the projections and predictions are far better than they were.

But what do you say to the people who say: Why can't that turn around very quickly? Why is it that a few months ago when CBO's forecast and the various other forecasts were very negative, they were all saying $200 billion or more? And now we see a figure of $100 billion in 1991.

It does not seem to depend on the change in the oil price; it does not seem to particularly, I don't believe, rely on the drop in interest rate.

For those of us in Congress who are not economists, it's very hard to understand the turnaround. So what can we rely on in this area?

Mr. HARRISS. I'm not an authority on shortrun forecasting. I think you will get a better response from the others.

Mr. ROBERTS. Senator Roth, I believe one of the factors was the belief that the interest rates could not fall because of the deficit and, therefore, they forecast larger interest payments on the debt.

The assumption was that the budget deficit would preclude falling interest rates. I think also, largely for propaganda reasons, there was a misperception of what was really happening to defense spending.

Senator ROTH. Was what?

Mr. ROBERTS. What was happening to defense spending.

Senator ROTH. Sure.

Mr. ROBERTS. You see, every year, when they would come out with a budget, they would show large projections over the next 5 years. But each year when the budget came out the base was always cut. Since everyone was focusing on the projected rise in the next year's budget, no one was looking at what was happening to the base of defense spending budget by budget. They just weren't looking at the budget in a meaningful way because, obviously, a meaningful way is what is happening, not what is projected. Since 1981, Reagan's defense base has been cut in real terms every year. The reduction was enormous between the last two budgets.

So I think these two major factors, plus other assumptions which, in the past, were taken at the extreme in order to dramatize the projected size of the deficit, account for the difference. There's no real reason to make so many budget assumptions at the extreme.

You can make them at a more reasonable level, and I think that is happening in both budget offices. Altogether, you get the change in deficit outlook because, as we all know, it wasn't produced by changing the economic assumptions. No one has forecast a better growth rate for the economy.

Senator ROTH. That's an important point.

Mr. ROBERTS. Yes; the political assumptions in the budget collapsed in the face of reality.

But this, or course, doesn't mean that the outlook on the budget will stay better. It doesn't mean that at all.

You always run the risk of the real economy doing worse. I think all of us agree that this tax reform with the uncertainty about the effective date and the provisions of the reform itself, together with the uncertainty about the direction of the thinking of the Federal Reserve—whether they're still fighting the battles of the seventies or whether they're in tune with the current environment—those things, in my view, will play a much larger role than the deficit per se in determining how well the economy does.

And I think how well the economy does will play the dominant role in what happens to the deficit. Any time the economy can grow faster than the Government's budget, the deficit is on a declining path. That's guaranteed.

Any time the economy grows less than the budget, either because the budget goes up or the economy goes down, the deficit gets bigger, and that's guaranteed, too.

So I think the focus on the performance of the economy has to be a key one in terms of the longrun deficit outlook.

Senator ROTH. What concerns me—and this point was alluded to a little earlier—is that instead of concentrating on the policies that are really going to make the economy grow, deficits have become the focal point of all considerations here. I oppose this large Government spending, but if I understand you gentlemen, it's not the most important thing if we're going to continue on this course of growth.

Mr. **Rahn**. I think you said it very well, Senator. The objective of economic policy ought to be to make economy grow as rapidly as possible, to have a sustained rise in real per capita income for all citizens.

That's what the focus of it is. The deficit is a residual of past policy mistakes and it, of course, could reverse if we have another serious policy mistake, as Mr. Roberts just laid out, particularly big dangers of the Fed clamping down on the economy and the second major danger right now, it seems to me, is misunderstanding on the part of the Congress on the tax bill, either increasing taxes or getting out a so-called tax reform bill which becomes destructive to economic growth.

Senator **Roth**. Mr. McKenzie.

Mr. **McKenzie**. I just see improved projections seem to be focusing on one side of the blade and that is reduced need to raise taxes, and for that reason you may want to get the news out.

But I'm not so sure but that the news is being held back because that news might reduce the pressure on Congress to cut the expenditure.

So I'm not so sure what will actually happen if the news gets out. In fact, my guess is the expenditure will be arising here in the near future simply becuse the Congress is seeking some sort of optimal deficit.

Senator **Roth**. Well, I wouldn't disagree with that. I think there is some concern, and rightfully so, that it would relieve pressure.

On the other hand, I don't think we should conceal that the best judgment of the economists is because we should try to act on the best information available to us. And, very frankly, I think a lot of the people who are talking about tax increases are not necessarily only thinking about deficits.

Maybe in part they are, but many of those people have traditionally been believers in large public spending, so I think that continues to be a problem. But it does seem to me rather foolhardy for us to be trying to set policy for growth and not be able to depend upon the factors that are the best economic analysis available.

It doesn't speak very highly of our governmental process if we have to conceal them. As I say, I don't think that there is a general awareness today of this fairly broad consensus.

I think the New York Times on the front page had a major article along these lines, that there was not an awareness of the optimistic projections, and Congress is still working, as it so often does, on old information or problems of yesterday.

Mr. **Harriss**. Your letter of invitation had a point to which I did not respond and I wanted to.

Mr. Rahn alluded to it. That is the question of further sequestration. I get Social Security benefits and they are scandalous. It seems to me no good reason why the sequestration policy should free Social Security from restrant.

Of course, I do not run for office.

Senator **Roth**. I think where they made the greatest mistake in Gramm-Rudman, to be candid, is when they exempted program after program.

I think it lost its thrust and became relatively ineffectual, and I'm not sure what will happen yet, although certainly something had to be done to make the Congress more conscious of the problem.

Gentlemen, are there any more comments you care to make at this time?

[No response.]

Senator **Roth**. If not, I would urge you and hope that you would get the word out because it is important, I think, that there be a better understanding of the thinking here on the Hill.

I think there continues to be gloom and doom and I fear they will take steps that may not be in the best interest of long-term growth because of that reception.

I agree with you, Mr. Rahn, the most important thing we can do is try to continue this path of growth. It's interesting to me that a constituent at home—a businessman—said, "You know, isn't it fascinating that the President may not be an economist but he seemed to be more right than many of the economists have in the last several years?"

I think that's true. Well, thank you, gentlemen. We were very fortunate to get you here and I hope that your good word will be spread among the Congress.

Thank you very much. The subcommittee stands adjourned.

[Whereupon, at 11:55 a.m., the subcommittee adjourned, subject to the call of the Chair.]

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